TAXATION SECTION
"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"
VOL. 4 ISSUE 3
SEPTEMBER 2008
TAXING TIMES

Revenue Procedure 2008-24 and Partial Annuity Exchanges: Where Are We?

by Kirk Van Brunt

The Internal Revenue Service (IRS) issued Rev. Proc. 2008-24 in March of this year, addressing the income tax treatment of so-called "partial annuity exchanges" ("partial exchanges"). Rev. Proc. 2008-24 answers some important questions, but it leaves other questions unanswered, particularly with respect to so-called "partial annuitizations." On balance, in Rev. Proc. 2008-24 the IRS has attempted to provide a fair solution to the partial exchange problem, but some of the terms of Rev. Proc. 2008-24 are open to interpretational debate and the ultimate utility of Rev. Proc. 2008-24 depends on how these interpretational issues are resolved.

This article begins with an overview of partial exchanges and the basic tax rules that they implicate. The article then reviews some of the history in this area leading up to Rev. Proc. 2008-24 and after that provides a detailed discussion of Rev. Proc. 2008-24. The article finishes with a discussion of partial annuitizations and "modified endowment contracts."

Overview

A holder of a "nonqualified" deferred annuity contract may wish to withdraw part of the account value of the contract and use the funds elsewhere.[1] Perhaps the easiest way to do this is to request the issuing insurance company to take the desired amount out of the account value and send the contract holder a check. This is referred to as a "partial withdrawal."

> *Example (1)*—John, age 54, purchased a deferred annuity contract in 2000 for $60,000, and now the account value has grown to $100,000. The contract was issued by XYZ Life Insurance Company. John wishes to withdraw the $40,000 of account value growth. XYZ sends him a check for this amount.

Partial withdrawals, however, can trigger adverse tax consequences. First, the partial withdrawal is treated as a distribution of taxable ordinary income to the extent of the "income on the contract."[2] In John's case, that means the entire $40,000 amount is taxable. Second, since John is under age 59½, a 10 percent premature withdrawal penalty applies (assuming no penalty exceptions apply).[3] In this case, this means that the income tax otherwise due on the $40,000 amount is increased by $4,000.

The partial exchange is an alternative to a partial withdrawal that may not have the same adverse tax consequences. What is a partial exchange? A partial exchange is a transaction in which the holder transfers a portion of the account value of an existing deferred annuity contract to the same or a new life insurance company in exchange for a new annuity contract. This may be done, for example, by assigning a portion of the contract's account value. The remaining portion of the account value of the original deferred annuity contract is then retained in the "old" contract.

> *Example (2)*—Instead of a partial withdrawal, on July 1, 2008, John assigns $40,000 of his contract's value to ABC life insurance company

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Actuaries
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TAXING TIMES
Vol. 4 Issue 3
September 2008

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This newsletter is free to section members. Current-year issues are available from the Publication Orders Department by contacting Aleshia Zionce at 847.706.3525
Photocopies of back issues may be requested for a nominal fee.

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SOCIETY OF ACTUARIES

FROM THE EDITOR

Important Revenue Procedures

BRIAN G. KING

Looking back over my past three years as editor of *Taxing Times*, I've come to appreciate the balance that exists between publishing timely articles while trying to adhere to a publication schedule. Inevitably, events occur between the production of issues of our newsletter that we simply cannot cover in the current issue of *Taxing Times*. This is the case this go-around. The Internal Revenue Service (IRS) issued five final revenue procedures that significantly improve the process for obtaining a closing agreement to correct the inadvertent failures of life insurance or annuity contracts to satisfy the requirements of sections 817(h), 7702 and 7702A of the Internal Revenue Code. The five revenue procedures are:

Rev. Proc. 2008-38
Closing Agreement to Remedy a Failure to Account for Charges for Qualified Additional Benefits Under the Expense Charge Rule of Section 7702(c)(3)(B)(ii)

Rev. Proc. 2008-39
Closing Agreement to Remedy Inadvertent Non-Egregious Failure to Comply with MEC Rules of Section 7702A.

Rev. Proc. 2008-40
Closing Agreement to Remedy the Failure to Meet the Definition of a Life Insurance Contract under Section 101(f) or 7702(a).

Rev. Proc. 2008-41
Closing Agreement to Remedy an Inadvertent Failure of a Variable Contract to Satisfy the Diversification Requirements of Section 817(h).

Rev. Proc. 2008-42
Procedure for Obtaining an Automatic Waiver under Section 7702(f)(8) or 101(f)(3)(H).

These revenue procedures—which became effective on July 21, 2008—are the result of a collaborative effort between government and industry aimed at simplifying the filing process and reducing the onerous nature of existing toll charge procedures, bringing the overall magnitude of toll charges in line with the underlying error giving rise to non-compliance.

Given the date that these revenue procedures were released relative to our publication schedule, there simply wasn't enough time to address them in this issue of *Taxing Times*—which may be a good thing given its length. Since our next issue of *Taxing Times* is scheduled for a February 2009 publication date, the Taxation Section is planning on issuing a special supplement of *Taxing Times* later this year that deals specifically with these five new revenue procedures. This will give us adequate time to understand the implications of these revenue procedures, research potential issues or questions that may exist and formulate informative articles on these revenue procedures.

I hope you enjoy this issue of *Taxing Times*, and look forward to the special supplement that is scheduled for later this year.

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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

Dear Mr. King,

I greatly appreciate the well-written article entitled, "NAIC Proposal for Mortality Under Pre-Need Life Insurance," in your May 2008 edition. It deals with the NAIC *Preneed Life Insurance Minimum Standards for Determining Reserve Liabilities and Nonforfeiture Values Model Regulation* (the Model Regulation). Prior to reading the article, it seemed to me that Internal Revenue Code (IRC) Section 807(d) literally required the use of the 2001 CSO during the Model Regulation's transition period, 2009–2011, assuming adoption by at least 26 states in 2008. After reading the article, I feel more comfortable in making this assertion, and, at the same time, recognize that there are points supporting use of the 1980 CSO during 2009–2011. The 1980 CSO would be used after 2011 as the 2001 CSO would not statutorily be *permitted to be used* by at least 26 states as required by IRC Section 807(d)(5)(A).

IRC Section 807(d)(5)(E), which addresses the situation of more than one applicable table, also supports the literal interpretation of Section 807(d)(5)(A) and the 2001 CSO as that table *generally yields the lowest reserves*. Note that given a group of tables that satisfy the other subsections of IRC Section 807(d), the final selected table dictated by IRC Section 807(d)(5)(E) is based on the one that generally yields the lowest reserves for the (in this case, pre-need) life insurance industry. It is not based on the best-fitting mortality table for the (pre-need) life insurance industry. Or does Section 807(d)(5)(E) apply only to selecting the version of the group of tables after the 1980 CSO group or 2001 CSO group has been determined?

When I focus on the Model Regulation transition period, I disagree with Anton L. Janik, Jr.'s *Letter to the Editor* in the May 2008 edition of the *Taxing Times*. The reason he gives for claiming appropriateness of the 1980 CSO during this period is precisely the reason that the 2001 CSO would instead be appropriate. Mr. Janik may be correct that the 1980 CSO is appropriate here, but his argument leads to the opposite conclusion. Mr. Janik should keep in mind that the 2001 CSO would not *become the prior-prevailing commissioners' standard table until* 2012, since the Model Regulation permits both the 1980 CSO and the 2001 CSO during 2009–2011.

IRC Section 807(d)(5)(A) says:

> IN GENERAL—The term "prevailing commissioners' standard tables" means, with respect to any contract, the **most recent commissioners' standard tables prescribed** by the National Association of Insurance Commissioners 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.

Which mortality table should be used during the Model Regulation transition period? A literal reading of IRC Section 807(d)(5)(A) leads to the conclusion that the answer is the 2001 CSO, since it is the more recent table, and it was *permitted to be used* since 2004. If instead the emphasized wording were "most recently prescribed commissioners' standard tables," then the answer would be the 1980 CSO for preneed insurance. I doubt that the situation of a prevailing statutory mortality table (2001 CSO) becoming effective and then becoming ineffective by replacement by an earlier table (1980 CSO) was anticipated as the tax law was developed. Is this enough to argue against the literal interpretation of IRC Section 807(d)(5)(A)?

The Model Regulation has been adopted by the NAIC Plenary on March 31, 2008, and preneed companies are pursuing expeditious state adoption. If for 2009 through 2011, the 2001 CSO is the appropriate table for IRC Sections 807 and 7702, then these companies will be adversely affected. This issue is sufficiently cloudy that it may end up being determined by the tax court. It would seem that the preneed companies may want to quickly seek NAIC approval of a revised Model Regulation followed by expeditious state adoption of it. Suppose, for example, that the Model Regulation is revised to eliminate the transition period and any possible use of the 2001 CSO after 2008 for preneed life insurance. If this revised Model Regulation were adopted by at least 26 states in 2008, then the only table "permitted to be used" in the context of IRC Section 807(d)(5)(A) would be the 1980 CSO. IRC Section 807(d)(5)(B) would permit, but not require, the use of the 2001 CSO for 2009 –2011. Thus, this revision would enable preneed business to legitimately use the 1980 CSO for tax purposes during 2009–2011 as desired. This could solve this issue from a tax standpoint but create other hardships during this period.

The views expressed here do not necessarily reflect those of my employer.

Sincerely yours,

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KORY J. OLSEN

With fall approaching, school, new classes, new books and learning new things are in our thoughts. I always enjoyed going back to school because I like to learn. School provides a definite structure for when learning time begins and ends. Of course, once we are out of school, the learning continues, but the defined structure is gone. It is no longer the purpose of the day, but a by-product of our daily encounters and experiences.

Occasionally during my day, I will receive questions from others regarding things I don't know or I will come across something that looks strange, and the learning begins. I will use my reference material and start to investigate. To me, the investigation and discovery process is like putting together a big puzzle and much more exciting than Sudoku. The best part is when all the pieces fit together.

Education Successes

The Society of Actuaries and the Taxation Section are a great source for reference material and learning opportunities. Two of the main goals of the SOA are providing basic and advanced education in the fundamental principles of actuarial science and professional development and conducting research to develop studies of historical experience and provide further expansion of the profession. The Taxation Section has been doing a great job and has made a significant impact with regard to education. It is a primary focus and has been covered in many ways including the content rich editions of *Taxing Times*, incorporating taxes in the actuarial exam material and seminars and meetings where the Section is involved.

The council is now giving some serious thought about the other goal, research. The Taxation Section's research projects have been limited in number, but have been very successful and highly beneficial. The research to date includes Required Minimum Distributions (Determining the "Actuarial Present Value" of Certain "Additional Benefits" Under Treasury Regulation Section 1.401(a)(9)-6, Q&A-12) and 2001 CSO Maturity Age (2001 CSO Implementation Under IRC Sections 7702 and 7702A). The results of both of these projects can be found on the SOA Web site under the Taxation Section.

Potential Research Projects

Our Section Council is investigating potential research projects and we welcome your ideas!

What reference material would be useful to you? What outstanding questions should be answered? Some of the criteria that are used to determine research projects include: (1) research that is actuarial in nature and (2) usefulness to Taxation Section members (*e.g.*, will it lessen or eliminate the need for members to do the research independently). Please send your ideas to me at *kory.olsen@pacificlife.com* or to John Palmer at *john_palmer@ohionational.com.*

Thank Yous All Around

As school years begin and end, so do council years. As this council year is drawing to a close, I would like to thank our council members for a great year. We have accomplished a great deal and have made significant preparations for next year. I would especially like to thank those council members whose terms will be expiring this year, including: Leslie Chapman, George Hebel, Brian King and Art Panighetti. They have made great contributions to the Section and we look forward to their continued participation as friends of the council.

I would also like to thank our friend of the council, Steve Chamberlin, for being our Spring Meeting coordinator. The section's Spring Meeting sessions went well, both at the Health and Life Meetings. His coordination efforts provided learning opportunities for many of our section members. I hope that you were able to attend one of these successful sessions.

Learning Opportunities

The section also has other learning opportunities coming up. The Product Tax Seminar is scheduled for September 8–10 and is expected to be as informative and successful as the prior ones. As usual, there will be participation from the Treasury and the Internal Revenue Service (IRS), providing a learning opportunity for all. The Taxation Section will also be sponsoring sessions at the annual meeting in October. The sessions will include Federal Income Tax Implications of Principle-Based Reserves and Tax Treatments & Traps—Life Products and Their Usage. We look forward to seeing you there.

If you are looking for a more personalized learning opportunity, I encourage you to volunteer for the Taxation Section. Let me know if you'd like to investigate this worthwhile opportunity. We can discuss what interests you and get you placed accordingly. There is no better learning than the hands-on approach.

I enjoy learning and I hope you do too. However, the one thing I miss most about school is still summer vacation!

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in exchange for ABC issuing to him a new deferred annuity contract. John now owns two annuities: the old XYZ annuity, now with an account value of $60,000, and the new ABC annuity, with an account value of $40,000.

What is the tax treatment of a partial exchange? John would like to take the position that this is an exchange of annuity contracts that is tax-free under section 1035. Under this view, John does not pay tax on the $40,000 amount and there is no $4,000 penalty tax either. Later, John may surrender or take withdrawals from either the new annuity or the old annuity and pay tax only by reference to the gain inside the particular contract involved. A premature withdrawal penalty may still apply, but since the taxable gain is less, the penalty will be less. If this treatment is correct, then a partial exchange is a more favorable tax strategy than a straight partial withdrawal.

There are, however, alternative ways to view a partial exchange. One way in particular, for example, would be to view a partial exchange as simply a withdrawal of money from the deferred annuity contract, which is then used to purchase a new annuity contract and which should be treated in the same manner as a straightforward partial withdrawal. Section 1035, one might argue, was not meant to be a tool for doing an end run around the rules applicable to partial withdrawals. Under this view, the fact that the money being withdrawn happens to be applied in a specific manner—*viz.*, to purchase another deferred annuity contract—should not matter; John should be taxed in the same manner as he would if he simply withdrew the $40,000 and spent it all on a new home theater system.

There is one final twist to consider. Back in 2000, let us assume that John wants to purchase the deferred annuity contract in question, but he is concerned about the adverse treatment of partial withdrawals. After some thought, John decides that he will ameliorate the adverse tax consequences by buying five separate deferred annuity contracts from XYZ for $12,000 each (for a total cost of $60,000). Each contract now has a value of $20,000 (for a total value of $100,000). Later, John decides to effect a withdrawal of $40,000 from the five contracts by completely surrendering two of them. Upon a complete surrender, the holder is taxable only on the amount received in excess of his investment in the contract. In this case, John has an $8,000 gain on each contract and thus pays tax on a total of $16,000 (as opposed to $40,000). While John still must pay a premature withdrawal penalty, the penalty in this case is $1,600, not $4,000. In this manner, John has cleverly lessened the adverse tax consequences that would have otherwise applied if John had just bought a single deferred annuity contract. Or has he? The answer is John's plan does not work. Congress anticipated this technique back in 1988 and enacted a special aggregation rule under which all annuity contracts issued by the same company to the same policyholder during any calendar year are treated as a single contract.[4] In addition, Congress gave the IRS broad regulatory authority to prescribe regulations to prevent avoidance of section 72(e).[5]

A premature withdrawal penalty may still apply, but since the taxable gain is less, the penalty will be less.

Some History

The appropriate tax treatment of a partial exchange has long been the subject of disagreement and debate. An appropriate starting point in reviewing the history of the issue is *Conway v. Commissioner*.[6] The facts of *Conway* are simple. Dona Conway bought a deferred annuity contract from Fortis Benefits Insurance Company in 1992 for $195,643. In 1994, she instructed Fortis to withdraw $119,000 from the contract and to make the check out to Equitable Life Insurance Company of Iowa. A check was issued by Fortis directly to Equitable for $109,000 ($119,000 minus a $10,000 surrender charge) and Equitable issued a new deferred annuity contract to Ms. Conway. On her tax return, Ms. Conway treated the transaction as a tax-free exchange under section 1035. On audit, the IRS treated the transaction, not as a section 1035 exchange, but as a simple partial withdrawal. The Tax Court sided with Ms. Conway, and rejected the IRS's argument that in order to qualify under section 1035, Ms. Conway would have needed to exchange the entire Fortis contract.

The IRS decided to acquiesce in the *Conway* decision, but with an important caveat. The taxpayer could not be guilty of using the partial exchange transaction purely as a device to avoid the adverse tax consequences of a partial withdrawal.[7] Thus, the IRS concluded, the taxpayer must leave the funds inside both the "old" contract and

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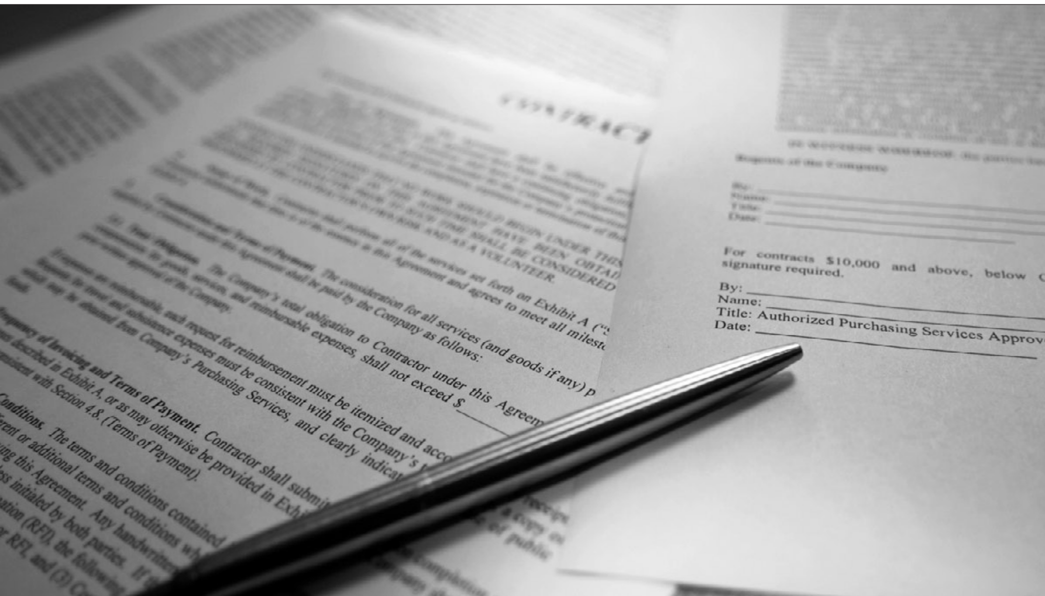

the "new" contract received in the exchange; the taxpayer cannot try to pull money out of either contract. An example of the type of transaction that concerned the IRS would be where, to refer to the partial exchange example (2) on page 1, John receives a new deferred annuity contract on July 2, 2008, and on July 3, John surrenders the new contract for $40,000. Obviously, John is in the same position he would have been in had he simply undertaken a partial withdrawal, and the IRS vowed to fight transactions of this ilk.

However, as long as the contract holder was willing to leave the money in the two contracts for some undefined period of time, the IRS agreed with the *Conway* case that a partial exchange would be treated as a tax-free exchange under section 1035. The obvious question that arose after the IRS's acquiescence was how long does the money have to remain in the contracts? When does the partial exchange transaction become "old and cold" relative to a later surrender of, or withdrawal from, one of the contracts? There was no clear answer to that question.

The upshot of the *Conway* case was that John could engage in the partial exchange transaction described in example (2) on page 1 and achieve the desired section 1035 treatment, provided John did not attempt to take any money out of either contract for some undefined period of time. However, if John did attempt to take money out of either contract too soon, the IRS reserved the right to challenge such transactions, the *Conway* decision notwithstanding.

In the aftermath of the *Conway* decision and the IRS's acquiescence therein, the industry pressed the IRS for further guidance on partial exchanges. In addition to the question of when the partial exchange transaction became "old and cold," various technical questions were raised, perhaps the most prominent being how the contract holder's original investment in the contract should be allocated between the old and new contracts. The IRS's response to these questions came in the summer of 2003 with the issuance of Rev. Rul. 2003-76[8] and Notice 2003-51.[9]

Rev. Rul. 2003-76 formally confirmed that a partial exchange involving facts similar to those in *Conway* would be treated as a valid section 1035 exchange, and it answered the question of how to allocate the investment in the contract. The allocation is done on the basis of the percentage of the cash value retained in the original contract and the percentage transferred to the new contract. Surrender charges are ignored.[10]

The other piece of guidance, Notice 2003-51, was more intriguing. It provided interim guidance, pending future regulations, on when a partial exchange would be respected as a tax-free section 1035 exchange and when it would be subject to attack as a tax avoidance device for dodging the adverse tax consequences that apply to partial withdrawals. Notice 2003-51 created a safe harbor. If the holder undertakes a partial exchange and does not surrender, or take a withdrawal from, either contract within 24 months of the date when the partial exchange was completed, the partial exchange transaction will be respected. However, if there is a withdrawal or surrender within 24 months, then the IRS will "consider all the facts and circumstances to determine whether a partial exchange and subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract . . . should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under 72(e)." Thus, if there is a surrender or withdrawal within 24 months, the contract holder runs the risk that the IRS will challenge the transaction.

Notice 2003-51 is somewhat vague about exactly how the IRS would treat a failed partial exchange. It could essentially ignore the purported exchange and continue to treat the old and new contracts as one contract, with the result that a later surrender or withdrawal from one of the contracts would be treated as a partial withdrawal from this single, integrated contract. Or, it could treat the purported exchange as simply a partial withdrawal, taxable immediately at the time of the exchange. The issue of how to treat a failed partial exchange attracted much debate within the insurance industry.

Notwithstanding the foregoing, Notice 2003-51 provided exceptions to this 24-month rule. Specifically, a surrender or withdrawal within 24 months would not be challenged by the IRS as a tax avoidance device if (i) one of the conditions of section 72(q)(2) or any other "similar life event, such as a divorce or the loss of employment" occurs after the partial exchange and before the surrender or withdrawal, *and* (ii) the surrender or distribution was not contemplated at the time of the partial exchange. Section 72(q) lists 10 situations in which a withdrawal from an annuity contract will not be subject to the 10 percent penalty tax. One of the most important situations is a distribution that occurs on or after the date that the taxpayer attains age $59\frac{1}{2}$.[11] Other situations exempt from the penalty tax include distributions on account of disability or death.[12] Finally, two other situations warrant mention: the penalty tax does not apply to a distribution (i) that is "a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary,"[13] or (ii) under an immediate annuity contract (within the meaning of section 72(u)(4)).[14]

What did this all mean? In very general terms, Notice 2003-51 created a safe harbor: if the taxpayer could keep all the money in the contracts for at least two years after the partial exchange, then the partial exchange would not be challenged as a tax avoidance device. If that is not possible, then Notice 2003-51 offered the taxpayer a way to rebut a presumption of tax avoidance: the partial exchange would still be respected if amounts are withdrawn subsequent to the occurrence of a section 72(q)(2) event or "life event," provided the distribution was not contemplated at the time of the partial exchange. Presumably the "no-contemplation" prong of this test was meant to ensure that the partial exchange was not being used to avoid the income-first rule of section 72(e)(4)(C), while the section 72(q)/"life event" prong was aimed at evasion of the section 72(q) penalty tax. Unfortunately, this two prong rebuttal proved impractical. One reason why was the requirement in Notice 2003-51 that the distribution in all events could not have been "contemplated" at the time of the partial exchange. This "no contemplation" rule seemed to inject a highly subjective, state-of-mind standard, which was difficult for insurance companies to monitor and police as a practical matter, and as a result, reliance on this two-prong rebuttal was too uncertain and risky for many.

So what happens if there is a surrender or withdrawal within 24 months and the section 72(q)(2)/"life event" exception is inapplicable? Notice 2003-51 states that the IRS will rely on general tax principles and examine all the facts and circumstances in order to determine whether to integrate the two contracts. It is an open question just how far the IRS could go in pursuing integration in reliance on general tax principles.

This "no contemplation" rule seemed to inject a highly subjective, state-of-mind standard, which was difficult for insurance companies to monitor and police as a practical matter. …

Taxpayers and insurance companies struggled to apply Notice 2003-51, and even partial exchange transactions that passed muster under Notice 2003-51 were not without controversy within the insurance industry.[15]

The reign of Notice 2003-51 lasted about five years. It was superseded earlier this year by Rev. Proc. 2008-24, which is addressed in the following section.

Rev. Proc. 2008-24

1. In General

On March 13, 2008, the IRS released Rev. Proc. 2008-24, superseding Notice 2003-51. Rev. Proc. 2008-24 represents a significant development in the evolution of the taxation of partial exchanges.

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Rev. Proc. 2008-24 follows the basic approach of Notice 2003-51 of distinguishing between "good" partial exchanges and "bad" partial exchanges based on whether and when the taxpayer tries to take money out of either the old or the new contract. However, Rev. Proc. 2008-24 makes several important changes and clarifications.

First, and perhaps most significant, the 24-month time period in Notice 2003-51 is shortened to 12 months. Thus, so long as there is no withdrawal from, or surrender of, either the old or the new contract within 12 months of the "date of transfer,"[16] the transaction will be respected as a valid tax-free section 1035 exchange. This means that the two contracts will be treated for tax purposes as two separate contracts; they will not be aggregated and treated as one contract.[17] Thus, the taxation of any subsequent withdrawal or surrender of either contract will be determined solely by reference to the income on the contract under each separate contract.

Second, even if there is a withdrawal or surrender within 12 months of the partial exchange, as under Notice 2003-51, the partial exchange will still be respected as a valid section 1035 exchange if a certain type of intervening event occurs. The type of event is one of certain situations listed in section 72(q)(2) or a "life event" (*e.g.*, divorce or loss of employment).[18] This follows the path blazed by Notice 2003-51. However, Rev. Proc. 2008-24 departs from Notice 2003-51 in two respects. First, the taxpayer cannot rely on the conditions in either section 72(q)(2)(D) (substantially equal periodic payments for life) or section 72(q)(2)(I) (an immediate annuity). This change relates to the issue of partial annuitization, which is discussed separately below. Second, Rev. Proc. 2008-24 dispenses with the overriding requirement of Notice 2003-51 that in order to qualify for the section 72(q)(2)/"life event" exception, distributions from the contract must not have been "contemplated" at the time of the partial exchange. Thus, if a qualifying section 72(q)(2) situation or a "life event" occurs, subsequent distributions within the initial 12-month period are permissible under Rev. Proc. 2008-24, apparently regardless of the fact that the taxpayer specifically contemplated that such distributions would occur when he or she entered into the partial exchange.

Third, Rev. Proc. 2008-24 clarifies what the tax consequences are if a partial exchange does not qualify as a tax-free exchange under section 1035, *i.e.*, distributions from either contract occur within 12 months of the partial exchange and the exception for the occurrence of a section 72(q)(2)/"life event" is inapplicable. Under Notice 2003-51, the IRS would examine the facts and circumstances of each case and determine whether under general tax principles the two contracts should be integrated and treated as one. This facts and circumstances test based on general tax principles was a little vague and somewhat impractical to administer, and Rev. Proc. 2008-24 jettisons this approach. Instead, if the terms under Rev. Proc. 2008-24 for obtaining section 1035 treatment are not met, the partial exchange will be treated as a taxable distribution of cash to the contract holder followed by a payment of the cash over to the insurance company for the second annuity, *i.e.*, as a partial withdrawal. Thus, the IRS has decided not to follow the alternative approach of treating the exchange as a nullity and continuing to treat the old and new contracts as one integrated contract.

Finally, Rev. Proc. 2008-24 clarifies that if a partial exchange otherwise qualifies as a tax-free section 1035 exchange under the terms of the Rev. Proc., the IRS will not aggregate the old and new annuity contracts pursuant to section 72(e)(12) or otherwise, even if both contracts are issued by the same insurance company.[19] Rather, as noted above, the two contracts will be treated as separate contracts.

2. Scope and Effective Date

Rev. Proc. 2008-24 applies to any partial exchange transaction, which is defined as the "direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies."[20] Rev. Proc. 2008-24 specifically does not apply to a partial annuitization transaction.[21]

Rev. Proc. 2008-24 is effective for partial exchanges where the cash surrender value transfer is completed on or after June 30, 2008.

3. Issues/Observations/Questions

a. *The 12-month seasoning period*—The 12-month period in Rev. Proc. 2008-24 is a brightline rule. Even if the taxpayer completely surrenders one of the contracts one moment after the 12-month period expires, the partial

exchange will be respected. Apparently it does not matter that the taxpayer may have intended, planned or arranged for a surrender of, or withdrawal from, a contract at the time the partial exchange was undertaken. All that matters is that 12 months have expired before the withdrawal event occurs. Like any bright-line rule, the 12-month rule has the benefit of providing certainty and ease of administrability, but at the cost of some arbitrariness.

If a taxpayer does wait out the 12-month period before taking some type of distribution from one of the contracts, the distribution will be taxed by reference to the investment in the contract and the income on the contract for that particular contract without regard to the other contract. The distribution may still be subject to the 10 percent penalty in section 72(q), but the taxpayer can rely on the exceptions under section 72(q)(2) to avoid the penalty. Significantly, the taxpayer can rely on the exception in section 72(q)(2)(D) for substantially equal payments paid out over the taxpayer's life or life expectancy.

b. *The role of intent*—Rev. Proc. 2008-24 drops the "no contemplation" requirement of Notice 2003-51. What should be made of this? Let us return to John's partial exchange transaction in example (2) on page 1. What if, the new ABC contract received in the partial exchange is a type of immediate annuity that commences annuity payments exactly one year and one day after the date of the partial exchange? In this situation, at the time of the partial exchange John has effectively entered into a binding contract to begin receiving payments under the new ABC contract on July 2, 2009. Normally, these facts could raise concerns about the partial exchange being disregarded under general tax principles, such as, for example, the "step transaction" doctrine, and indeed this transaction would have raised serious questions under Notice 2003-51. Does Rev. Proc. 2008-24 change anything?

Maybe it does. Rev. Proc. 2008-24 states unequivocally, and without any kind of qualification, that if John waits for one year before surrendering the ABC contract, "[the partial exchange] will be treated as a tax-free exchange under section 1035" and "the Service will not require aggregation pursuant to the authority of § 72(e)(12), or otherwise, of the [XYZ contract and the ABC contract]."[22] Moreover, Rev. Proc. 2008-24 also says that only if John surrenders the ABC contract one day too early (assuming there is no intervening 72(q)/"life event") will "[the partial exchange] be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract." Taken together, these two statements do not seem to leave the IRS with much wiggle room to challenge John's surrender of the ABC contract a year and day after the partial exchange on step transaction or other grounds. If, and only if, John fails to wait one year will the partial exchange be invalidated. At least, that is what the plain words of Rev. Proc. 2008-24 state. And there is seemingly no reason to take those plain words at anything other than face value, particularly given the fact that Rev. Proc. 2008-24 specifically drops the requirement of Notice 2003-51 that future distributions or withdrawals not be contemplated. As Notice 2003-51 evidences, the IRS knows how to reference "general principles of tax law" when it thinks they should be relevant to the analysis of a partial exchange, and Rev. Proc. 2008-24 clearly has no such qualification or caveat.

While there may be understandable hesitancy about interpreting Rev. Proc. 2008-24 in the foregoing manner, this reading is nevertheless defensible and reasonable, when one understands that Rev. Proc. 2008-24 is creating a brightline rule for both the IRS and taxpayers to follow. The one-year waiting period cuts both ways. Some "innocent" transactions that occur or would occur within one year may be invalidated, and some "guilty"

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transactions that occur after one year may be permitted. But that is what brightline rules do. Rev. Proc. 2008-24 evidences an entirely reasonable conclusion that the administrative burdens on both taxpayers and the IRS of trying to police partial exchanges under "general principles of tax law" and the vagaries of subjective intent is not justified.

Taxpayers, therefore, are probably well advised to avoid transactions that might be vulnerable to a sham transaction challenge.

Notwithstanding the foregoing, would the IRS try to challenge a partial exchange that fully complies with Rev. Proc. 2008-24 as lacking economic substance and any independent business purpose beyond the avoidance of tax, and on that basis seek to have it disregarded as a sham? Probably yes—in cases that the IRS considered particularly egregious. Taxpayers, therefore, are probably well advised to avoid transactions that might be vulnerable to a sham transaction challenge.

c. *The section 72(q)(2) exceptions*—If a distribution from one of the contracts occurs within the 12-month period, the partial exchange will be respected as a valid section 1035 exchange only if one of the permitted exceptions under section 72(q) or a "life event" occurs "between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender." Rev. Proc. 2008-24 is thus fairly specific about the time when the event must occur: the particular condition or event has to "occur" after the date of the partial exchange. There is some reason to question whether this is what was actually intended. For example, one section 72(q)(2) exception specifically referenced in Rev. Proc. 2008-24 is the exception in section 72(q)(2)(F) for distributions "allocable to investment in the contract before Aug. 14, 1982." The event, here, is the investment of premiums in an annuity contract before Aug. 14, 1982, which by definition will have occurred before the date of any partial annuity exchange subject to Rev. Proc. 2008-24. This apparent conflict could be resolved by interpreting "occurred between" as including section 72(q)(2) events that either actually occur between the relevant dates or that are "in existence between" those dates.

The "occurred between" issue is particularly significant with respect to the exception in section 72(q)(2)(A) for distributions on or after the date the taxpayer attains age 59½. Rev. Proc. 2008-24 literally states that only taxpayers who attain age 59½ after the partial exchange date could rely on the age 59½ exception, whereas taxpayers who attained age 59½ before that date could not. If one believes that attainment of age 59½ should be a critical factor in deciding whether distributions are permitted, as Rev. Proc. 2008-24 clearly does, then it does not seem to make much sense to deny the benefit of this exception to taxpayers that attain age 59½ before the partial exchange date.

However unintended and questionable the "occurred between" requirement may be, it is difficult to see how the words can be interpreted in a way that avoids the problem. Probably further, formal clarification from the IRS on this issue is necessary. And indeed, at this time, the insurance industry is actively pursuing such clarification.

d. *Indirect exchanges*—Rev. Proc. 2008-24 applies to "direct transfers" of cash surrender portions, which in this context means the funds go directly from one contract into the other. Thus, Rev. Proc. 2008-24 precludes from its scope so-called "indirect" transfers, where a check is issued to the taxpayer, who then endorses it over in payment for the second contract. This is consistent with the IRS's position that such indirect transfers cannot qualify as a tax-free exchange under section 1035, at least in the case of nonqualified contracts.[23] However, the Tax Court has held that an indirect transfer can qualify as a tax-free section 1035 exchange in appropriate cases.[24] Whatever the status of such indirect exchanges generally under section 1035, they are outside the scope of Rev. Proc. 2008-24.

e. *Effective date*—As noted above, Rev. Proc. 2008-24 is effective for partial exchange transfers that are completed on or after June 30, 2008. However, Notice 2003-51 is seemingly superseded immediately upon the issuance of Rev. Proc. 2008-24 on March 13, 2008. If that is correct, then it is not entirely clear how a partial exchange should be treated if it occurs after March 13, 2008, when Rev. Proc. 2008-24 was issued, but before its effective date.

What About Partial Annuitizations?

Rev. Proc. 2008-24 specifically excludes from its scope "partial annuitization" transactions, which are also on

the current "no ruling" list pending future guidance.[25] The tax stakes involved with partial annuitizations relate to whether the partial annuity payments can be treated as "amounts received as an annuity" for purposes of section 72.[26] If so, then an exclusion ratio can be computed with respect to such payments and based on that ratio a portion of each payment would be excludible from gross income as a return of the holder's investment in the contract. If the payments are not "amounts received as an annuity," then by definition they are "amounts not received as an annuity" and they will be subject to taxation as a series of partial withdrawals.[27]

Rev. Proc. 2008-24 defines a "partial annuitization" as a transaction in which "the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis."[28] This definition, by its terms, only encompasses a case where a portion of the cash value of a contract is applied under the terms of that same contract (*e.g.*, a specified settlement option under the contract) to the provision of annuity payments. The transaction occurs all within the confines of a single contract and can be referred to as a "same contract" partial annuitization.

A slightly different approach to achieving a partial annuitization is to have a portion of the cash value of one contract assigned toward the purchase of a separate, single premium immediate annuity contract,[29] either from the same company or a different one. This type of partial annuitization is actually a special type of partial exchange, and as discussed above, this type of transaction is within the literal scope of Rev. Proc. 2008-24. (See the example discussed previously where John exchanges part of his contract for a type of immediate annuity that commences a year and a day after the date of the partial exchange.)

Since Rev. Proc. 2008-24 excludes "same contract" partial annuitizations from its scope, the tax treatment of these transactions remains an open issue. Arguments can be made that under existing law "same contract" partial annuitization payments can qualify as "amounts received as an annuity," but technical issues exist, perhaps the most significant being the definition of the "annuity starting date." These issues have been addressed elsewhere and are beyond the scope of this article.[30] Until future guidance is forthcoming facilitating "same contract" partial annuitizations, taxpayers seeking to partially annuitize their contracts should do so *via* a partial exchange involving the acquisition of a new, second contract from either the same company or a different one. Under Rev. Proc. 2008-24, the partial exchange approach should achieve the desired tax treatment if one of the section 72(q)(2) exceptions (or other "life event") is applicable. The one section 72(q)(2) exception of particular significance here is the exception in section 72(q)(2)(A) for taxpayers who attain age 59½ after the partial exchange date. Alternatively, if the section 72(q)(2)(A) exception is inapplicable, the desired tax treatment can be achieved if the payments under the single premium immediate annuity received in the exchange are scheduled to start no earlier than a year and day after the partial annuity exchange, *i.e.*, by relying on the general 12-month rule in Rev. Proc. 2008-24.

Whither Modified Endowment Contracts?

Rev. Proc. 2008-24 only applies to partial exchanges of annuity contracts, not partial exchanges involving a life insurance contract. However, a certain class of life insurance contracts, so-called "modified endowment contracts" or "MECs,"[31] are taxed in a manner similar to nonqualified deferred annuity contracts. Like an annuity, partial withdrawals from MECs are taxable as ordinary income to the extent of the income on the contract,[32] and any amounts withdrawn from a MEC are potentially subject to a 10 percent penalty that largely tracks section 72(q). Given this similarity in taxation, it may be appropriate for the IRS to issue some form of guidance similar to Rev. Proc. 2008-24 addressing MECs.

As a practical matter, it is probably a relatively unusual situation where someone has purchased a MEC and subsequently desires to undertake a partial exchange. One notable exception, however, relates to life insurance purchased by corporations on the lives of their employees as a funding vehicle for providing employee benefits (*e.g.*, retiree health benefits). This is a common transaction and frequently the policies are all single premium life insurance policies, *i.e.*, MECs. Because these policies are typically all purchased at the same time from the same company, they are all aggregated and treated as a single life insurance policy for purposes of section 72(e).[33] The effect of this aggregation rule, unfortu-

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nately, is that if the employer should surrender one of the policies, the surrender can be treated as a partial withdrawal from a single MEC.[34] Yet sometimes there is a legitimate need to surrender a policy. For example, when an employee separates from service or no longer is entitled to benefits, there may be no longer a need or a desire to retain life insurance on this individual, and indeed, some states give such an employee a right to require his or her employer to terminate life insurance purchased on his or her life. Other business reasons may also arise that make it prudent for an employer to terminate previously purchased life insurance on one of its employees. In these circumstances, where the disposition of the life policy is necessary for independent business reasons, it would be appropriate, for example, to allow the employer to exchange the policy for an immediate annuity contract.[35] These circumstances are analogous to the type of "life event" referenced in Rev. Proc. 2008-24.[36]

Until guidance is issued on exchanges involving aggregated MECs, the tax treatment of such MEC exchanges is unclear.

Conclusion

Rev. Proc. 2008-24 is a positive development and a step in the right direction, but more needs to be done. Hopefully, in the not too distant future the IRS will clarify how the section 72(q)(2) exceptions apply and address the issue of "same contract" partial annuitizations.

An additional issue not addressed by Rev. Proc. 2008-24, which warrants further consideration by the IRS, is partial exchange transactions involving MECs. The IRS should specifically consider expanding the scope of Rev. Proc. 2008-24 to include MECs.

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End Notes

1 The tax treatment of "qualified" annuity contracts is beyond the scope of this article.
2 *See* section 72(e)(2)(B)(i) (the "income first rule"). "Income on the contract" refers to the excess of the cash surrender value of a contract (ignoring surrender charges) over the "investment in the contract." *See* section 72(e)(3)(A). "Investment in the contract," in turn, means premiums or other consideration paid, less any previously untaxed withdrawals. *See* section 72(e)(6).
All section references, unless noted, are to the Internal Revenue Code of 1986, as amended.
3 *See* section 72(q)(1).
4 Section 72(e)(12)(A)(ii). A separate aggregation rule also applies to modified endowment contracts. *See* section 72(e)(12)(A)(i).
5 *See* section 72(e)(12)(B) ("The Secretary may by regulations prescribe such additional rules as may be necessary or appropriate to prevent avoidance of the purposes of [section 72(e)] through serial purchases of contracts or otherwise.").
6 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi.
7 *See* AOD 1999-016 (Nov. 26, 1999).
8 2003-2 C.B. 355.
9 2003-2 C.B. 361.
10 *See also* PLR 200342003 (July 9, 2003) (applying Rev. Rul. 2003-76).
11 Section 72(q)(2)(A).
12 Section 72(q)(2)(B) & (C).
13 Section 72(q)(2)(D).
14 Section 72(q)(2)(I).
15 *See*, *e.g.,* Letter from Susan Seabrook to Michael Desmond (Treasury Dept.), Mark Smith (Treas. Dept.), and John Glover (IRS), dated Aug. 15, 2007, 2007 TNT 173-25.
16 The "date of transfer" means the date "on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange." Rev. Proc. 2008-24, § 4.01(a).
17 Rev. Proc. 2008-24, § 4.03.
18 Rev. Proc. 2008-24, § 4.01(b).
19 Rev. Proc. 2008-24, § 4.03.
20 Rev. Proc. 2008-24, § 3.01.
21 Rev. Proc. 2008-24, § 3.02.
22 Rev. Proc. 2008-24, § 4.03.
23 *See* Rev. Rul. 2007-24, 2007-21 I.R.B. 1282.
24 *See Greene v. Commissioner*, 85 T.C. 1024 (1985).
25 Rev. Proc. 2008-3, § 5.02, 2008-1 I.R.B. 110 (Jan. 4, 2008).
26 *See* Treas. Reg. § 1.72-2(b)(2) (defining "amounts received as an annuity").
27 *See* section 72(e).

[28] Rev. Proc. 2008-24, § 3.02.

[29] The term "single premium immediate annuity" is used here with its common industry meaning. No implication is intended whether the contract would constitute an immediate annuity within the meaning of section 72(u)(4).

[30] *See, e.g.*, Letter from Joseph F. McKeever, III, and Mark E. Griffin, to Donald J. Drees and Sheryl B. Flum (IRS), dated February 21, 2007, 2007 TNT 40-28.

[31] The definition of a MEC is set forth in section 7702A.

[32] *See* section 72(e)(10).

[33] *See* section 72(e)(12)(A)(i).

[34] Rev. Rul. 2007-38, 2007-25 I.R.B. 1420, holds that an exchange of some of the MECs for new life insurance policies issued by a different carrier will be respected as a valid section 1035 exchange and the new policies will not be aggregated with the old policies. But Rev. Rul. 2007-38 does not apply to a surrender, rather than an exchange, of the old policies. Moreover, it is an open question how Rev. Rul. 2007-38 would apply to an exchange of old policies for new policies, where the new policies are promptly surrendered.

[35] If the life policy-immediate annuity exchange is respected as a valid section 1035 exchange, it should not trigger the 10 percent penalty tax in section 72(v). Other issues, such as the application of section 264(f) to the immediate annuity contract, are beyond the scope of this article.

[36] Rev. Rul. 92-95, 1992-2 C.B. 43, by its terms, should not apply in this situation, but clarification may nevertheless be desirable that the principles of that Rev. Rul. will not be extended to a MEC-for-immediate annuity exchange.

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New IRS Letter Ruling Provides Guidance on Substantially Equal Periodic Payments from Immediate Variable Annuities

By John T. Adney, Bryan W. Keene and Alison L. Reynolds

The Internal Revenue Service (the "Service") recently released a new private letter ruling, PLR 200818018 (Jan. 29, 2008), that provides guidance on the treatment of variable annuity payments as "substantially equal periodic payments" (or "SEPPs") for purposes of the definition of "immediate annuity" under section 72(u)(4).[1] The ruling is significant for at least two reasons. First, it is the only ruling to date to confirm that variable annuity payments can constitute SEPPs for purposes of section 72(u)(4). To the extent prior rulings regarding SEPPs involved variable annuities, they addressed only partial withdrawals during the accumulation phase of the contracts. Second, the ruling concludes that a methodology for calculating variable annuity payments that differs from, but is actuarially equivalent to, a more traditional "annuity unit" methodology can produce SEPPs. This conclusion represents a logical and reasonable interpretation of the legislative history of another Code provision that includes a SEPP requirement, which indicated that SEPPs include variable annuity payments that are based on a constant number of annuity units that fluctuate in value. This article summarizes the new private letter ruling and discusses its significance in light of the prior available guidance regarding variable annuities and SEPPs.

Background on Immediate Annuities and SEPPs

Section 72(u)(4) defines an "immediate annuity" as an annuity (1) that is purchased with a single premium or annuity consideration, (2) the annuity starting date of which commences within a year of purchase, and (3) that provides for a series of SEPPs to be made at least annually. A contract's status as an immediate annuity can be relevant for several reasons. First, section 72(u)(1) generally denies annuity tax treatment for any annuity contract held by a non-natural person (*e.g.,* a corporation), but this rule does not apply to an immediate annuity.[2] Second, section 72(q) imposes a 10 percent penalty tax on certain "premature" distributions from non-qualified annuities, that is, annuities purchased with after-tax monies and that are not part of a qualified retirement plan or similar arrangement. This penalty tax does not apply to distributions from an immediate annuity as defined in section 72(u)(4).[3]

In addition to its relevance to the definition of an immediate annuity, the concept of SEPPs is important in two related circumstances. Specifically, a separate exception to the section 72(q) penalty tax is available for distributions that are part of a series of SEPPs made at least annually for the life or life expectancy of the taxpayer (or joint lives or joint life expectancies of the taxpayer and a beneficiary).[4] A contract does not need to be an immediate annuity for this exception to apply; rather, the partial withdrawals or annuity payments from the contract need only constitute SEPPs over life or life expectancy. In addition, section 72(t) imposes a similar 10 percent penalty tax on certain premature distributions from "qualified" annuity contracts, such as section 401(k) plans and individual retirement annuities under section 408(b). In that context, a similar exception is available for SEPPs paid over life or life expectancy.[5]

Legislative History Addressing SEPPs

Congress added section 72(u) to the Code in 1986 in order to preclude the use of non-qualified deferred annuities by employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees and to remove a perceived disincentive that such a funding opportunity created for employers' use of qualified retirement plans.[6] As originally enacted, the provision included the exception for immediate annuities as defined in section 72(u)(4), but the definition did not include a SEPP requirement. Congress added that requirement two years later, as part of the Technical and

Miscellaneous Revenue Act of 1988 ("TAMRA"),[7] and made the amendment retroactive to the 1986 effective date of section 72(u). The TAMRA legislative history indicates that the SEPP requirement was intended to "prevent the structuring of a contract that appears to be an immediate annuity contract, but that is in substance a deferred annuity."[8] The legislative history includes a brief statement that a joint and reduced survivor annuity will not fail to satisfy the SEPP requirement, but it does not elaborate further on what constitutes SEPPs, including how variable annuity payments might be treated.[9]

Although the legislative history of section 72(u) sheds little light on the treatment of variable annuity payments under the SEPP component of the immediate annuity definition, the legislative history of section 72(q) provides some guidance on SEPPs and variable annuity payments. As indicated above, in addition to the exception for immediate annuities, section 72(q) includes an exception to its 10 percent penalty tax for distributions that are in the form of SEPPs for life or life expectancy. In general, Congress added section 72(q) to the Code in 1982 in order to discourage the use of non-qualified deferred annuities as short-term investment vehicles, and instead to encourage their use towards the "worthy ideal" of meeting long-term investment and retirement goals.[10] Thus, pre-retirement distributions generally were penalized, but because SEPPs for life or life expectancy would provide income throughout retirement they were excepted from the penalty. With regard to how variable annuities might comply with the SEPP exception to the penalty tax, the 1982 legislative history of section 72(q) states that "the requirement that the amount be paid out as one of a series of [SEPPs] is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same."[11]

Published Guidance

The Service has not published any guidance on which taxpayers can rely for purposes of determining whether the SEPP component of the section 72(u)(4) definition of immediate annuity is satisfied. However, it has published guidance on how to calculate SEPPs for purposes of the exceptions to the sections 72(q) and (t) penalty taxes for SEPPs made over life or life expectancy.

In Notice 89-25,[12] the Service stated that payments will satisfy the SEPP exception to the section 72(t) penalty tax if they are determined in accordance with one of three methods described in the Notice. The three methods generally involve dividing an "account balance" by a factor specifically defined in the Notice, which produced a specific dollar amount that could be withdrawn from the account on a level basis for life or life expectancy. While such an approach could work for partial withdrawals from the "account balance" of a deferred annuity, it was not necessarily workable for determining variable annuity payments after the annuity starting date. However, one of the methods described in the Notice was based on compliance with the required minimum distribution ("RMD") rules of section 401(a)(9), which include rules that specifically apply to variable annuity payments. To that extent, the Notice could be read as equating SEPPs with an RMD-compliant variable annuity stream.

Subsequently, the Service published Rev. Rul. 2002-62,[13] which modified Notice 89-25 to provide additional definitions and special rules regarding SEPPs for purposes of section 72(t). One of those modifications was to define more specifically the RMD method for calculating SEPPs as consisting of an account balance divided by a factor determined under the RMD rules. Thus, perhaps unintentionally, Rev. Rul. 2002-62 appeared to eliminate Notice 89-25's implicit incorporation of the RMD rules for variable annuity payments into the rules governing SEPPs under section 72(t). This, in turn, led to some uncertainty regarding the availability of published guidance to rely upon in concluding that variable annuity payments could constitute SEPPs for purposes of section 72(t).

In Notice 2004-15,[14] the Service stated that any of the methods described in Notice 2002-62 could be used to satisfy the SEPP exception to the section 72(q) penalty tax. The Notice stated that this approach was acceptable because section 72(t) and section 72(q) "were enacted for the same purpose," namely, to discourage pre-retirement distributions from annuity contracts. The Notice, however, did not specifically reference the meaning of SEPPs in the context of section 72(u)(4). In that regard, because section 72(u) generally is directed at denying non-natural persons the benefits of tax deferral provided by a non-qualified deferred annuity, the SEPP component of the immediate annuity exception to section 72(u)(1) could be viewed as protecting against "back-loading" of annuity payments that would enhance the tax deferral effects of the annuity. In contrast, because sections 72(t) and (q) generally were enacted to discourage pre-retirement distributions from annuity contracts, the SEPP exceptions to those provisions might be viewed as protecting against "front-loading" of annuity payments that would accelerate the premature receipt of retirement savings.

As indicated above, the Service seemed to suggest in Notice 2004-15 that the reason the section 72(t) guidance

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on SEPPs could apply to section 72(q) was because those provisions were enacted for the same purpose. In light of this statement, the difference between the "anti-back-loading" intent behind section 72(u) and the "anti-front-loading" intent behind the penalty tax provisions of sections 72(q) and (t) might suggest that the SEPP requirement has a different meaning under section 72(u) than it does under sections 72(q) and (t). Of course, section 72(q) also includes a separate exception to the penalty tax for payments under an immediate annuity, which incorporates the SEPP requirement of section 72(u)(4)(C) and therefore supports a consistent interpretation of that term. At a minimum, however, the differences between the provisions and the statement in Notice 2004-15 made some ponder how much weight should be given to the statements that appeared in the legislative history of section 72(q) regarding variable annuity payments that are calculated using an "annuity unit" methodology when analyzing the SEPP component of section 72(u)(4)(C).

Prior Letter Rulings

In addition to the published guidance summarized above, the Service has issued multiple private letter rulings regarding SEPPs.[15] Most of those rulings have involved interpreting Notice 89-25 and Rev. Rul. 2002-62 in the context of section 72(t).[16] To the extent that the rulings have involved variable annuities, they have focused on applying the methods described in the published guidance to the account balance of such contracts during their accumulation phase. In other words, variable annuity payments were not addressed. Moreover, the rulings involving deferred variable annuities have taken inconsistent (and in some cases incorrect) views on how the SEPP requirement applies to them.

In particular, PLR 9115041 (Jan. 15, 1991) involved a non-qualified deferred variable annuity contract under which a "systematic withdrawal" option was available during the accumulation phase. Under the option, the owner could make a revocable election to begin receiving a series of partial withdrawals from the cash value of the contract in a specified dollar amount. The dollar amount was to be determined using a method that appeared consistent with one of the methods described in Notice 89-25. Nonetheless, the Service concluded that the resulting withdrawals would not constitute SEPPs for purposes of section 72(q)(2)(D).

In reaching this conclusion, the Service reasoned that the Notice 89-25 method that the taxpayer intended to use provided only for a level amortization of the account value of a fixed annuity contract, and that in order for a variable annuity contract to satisfy the SEPP exception "the number of annuity accumulation units withdrawn to make each periodic distribution must remain the same." In other words, the Service acknowledged the legislative history of section 72(q) regarding the "annuity unit" methodology, but then interpreted that legislative history as applying to variable annuities during the accumulation phase. This effectively meant that the "annuity unit" methodology was the only acceptable means of calculating SEPPs under a deferred variable annuity. Thus, the conclusion appears to have misapplied that legislative history to deferred variable annuities, thereby denying SEPP treatment for distributions that clearly would have been SEPPs if distributed from any other deferred annuity contract.

Continuing this questionable logic, the ruling then stated that, because section 72(q)(2)(D) requires SEPPs to be paid over life or life expectancy, the rule "presupposes that the distribution method must create a fixed or determinable future payment stream" that can be calculated on the date the first payment is received, and that otherwise "a taxpayer would be unable to determine on receipt whether the distribution is part of a series of [SEPPs] or simply a discrete withdrawal." For this reason, the Service concluded that the contract owner's ability to revoke or modify the systematic withdrawal election was fatal to the treatment of the resulting distributions as SEPPs, because the election did not "fix either the amount or duration of payments under the Policy." Presumably shocked by this reasoning in the absence of any statutory, regulatory, or judicial guidance imposing a "fixed and determinable" requirement for SEPPs in any context, the taxpayer formally asked the Service to reconsider its view on the facts presented. The Service responded by affirming the ruling.[17]

However, logic and reason ultimately prevailed on this question, when the Service later issued a private letter ruling reaching the opposite conclusion on virtually identical facts. Like the earlier ruling, PLR 200014024 (Jan. 6, 2000) involved a non-qualified deferred variable annuity contract under which a systematic withdrawal option was available.[18] Like the earlier ruling, the dollar amount of each partial withdrawal was to be determined using one of the methods set forth in Notice 89-25, and the contract owner could revoke or modify the election to receive partial withdrawals under the systematic withdrawal option. The Service cited the section 72(q) legislative history regarding variable annuity payments, but did not draw the same erroneous conclusion regarding

the applicability of that language during the accumulation phase of a deferred variable annuity. Rather, the Service concluded that the resulting distributions would qualify as SEPPs for purposes of section 72(q)(2)(D). The Service subsequently issued additional rulings of the same ilk, under both section 72(q) and section 72(t).[19] However, none of the rulings expressly addressed the SEPP requirement in the context of variable annuity payments received after the annuity starting date; *i.e.*, none correctly applied the legislative history of section 72(q)(2)(D). Moreover, none of the rulings involving variable annuities addressed the SEPP requirement in the context of section 72(u)(4).

In that regard, it appears that prior to PLR 200818018 only two letter rulings have dealt with the definition of an immediate annuity under section 72(u)(4). In PLR 9237030 (June 16, 1992), the Service considered the treatment of a "nonvariable" immediate annuity contract under that section. The contract provided for monthly annuity payments to be made at a guaranteed minimum amount for the annuitant's life, beginning within one month of purchase. The carrier could periodically increase or decrease the amount of the monthly payment based on interest rate adjustments, but the payments would never fall below the guaranteed amount. The contract also provided an "account value" after the annuity starting date, which the owner could access via a partial withdrawal or full surrender. After concluding that the guaranteed payments would be treated as amounts received as an annuity and entitled to an exclusion ratio under section 72(b), and that any periodic payment received in excess of the guaranteed payments would be treated as a dividend that was not received as an annuity, the Service addressed the treatment of the payments as SEPPs.

The Service began its analysis by quoting the TAMRA legislative history regarding the intent of the SEPP requirement in the context of section 72(u). It then summarized that intent as a congressional effort "to minimize any possibility of deferral of taxation beyond the deferral inherent in the section 72(b) exclusion ratio applicable to a level payment annuity." In light of that intent, the Service noted that there could be some variation in the amount of the monthly payments under the contract involved in the ruling, depending on whether the carrier upwardly adjusted the guaranteed minimum payment based on relevant interest rate considerations. However, the Service observed that any such changes were not prescheduled and were outside of the owner's control. The Service also observed that any excess interest would be currently paid to the taxpayer and that the periodic payments would fully amortize the contract's principal over the payment stream's duration. It characterized the possible excess interest payments as dividends received after the annuity starting date, and concluded that such dividends would not prevent the contract from qualifying as an immediate annuity contract. In that regard, the Service reasoned that section 72(u)(4)(C) (imposing the SEPP requirement) does not require that all distributions from an immediate annuity contract be in the form of SEPPs, and that there is no prohibition of non-periodic distributions in the nature of dividends after the annuity starting date. Based on these considerations, the Service concluded that the payments would constitute SEPPs within the meaning of section 72(u)(4)(C). In effect, the Service reached a conclusion that is fully consistent with the legislative history of section 72(q)(2)(D) regarding variable annuity payments, in that the ruling and the legislative history involve periodic payments that can fluctuate based on certain changes in interest rates or the investment performance of separate account assets. However, the ruling did not involve a variable annuity and the Service did not cite to that legislative history in reaching its conclusion.

> The carrier could periodically increase or decrease the amount of the monthly payment based on interest rate adjustments, but the payments would never fall below the guaranteed amount.

The other private letter ruling addressing section 72(u)(4) was PLR 200036021 (June 7, 2000). In that ruling, the Service considered a non-qualified immediate annuity contract that had features similar to the contract involved in PLR 9237030. For example, the contract provided for fixed monthly annuity payments over a stated duration. Although the contract did not provide a "cash value," it did provide a "commuted value" that the owner could access after the annuity starting date. The carrier could declare excess interest payments from time to time, which would either be added to the commuted value or paid immediately to the owner in a dividend-like distribution. The Service concluded that the amount of the monthly annuity payments would remain unchanged despite the potential for dividend-like

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payments based on interest rate improvements, and that the payments therefore satisfied the SEPP requirement of section 72(u)(4)(C). Like the earlier ruling, the Service did not cite the legislative history of section 72(q)(2)(D) regarding variable annuity payments in reaching this conclusion, and the ruling did not technically involve a variable annuity contract. Thus, prior to the recent issuance of PLR 200818018, there were no rulings addressing the treatment of variable annuity payments under section 72(u)(4)(C). Likewise, no rulings squarely addressed the treatment of such payments under the SEPP exceptions to the penalty taxes imposed by sections 72(q) and (t).

A "minimum payment option" also is available, which provides that periodic payments will never fall below an amount specified in the Contract that is less than the initial periodic payment.

Facts of PLR 200818018

In PLR 200818018, the taxpayer life insurance company intended to issue certain single premium, non-qualified annuity contracts (each, a "Contract"). According to the ruling's statement of facts, each Contract will provide for periodic payments for the life of an annuitant during two distinct "phases"— "Phase I" and "Phase II." During Phase I, the Contract owner can take withdrawals from the Contract's "account value" or surrender the Contract in full, and if the annuitant dies the remaining account value is payable either in a lump sum or as continued periodic payments. Phase II begins at the completion of Phase I, during which periodic payments will continue for the life of the annuitant. A "minimum payment option" also is available, which provides that periodic payments will never fall below an amount specified in the Contract that is less than the initial periodic payment. This option can be terminated after issuance, and the minimum payment will be reduced pro rata by any withdrawal during Phase I.

Upon issuance of the Contract, the owner must make irrevocable elections regarding the following factors to be used in calculating periodic payments: (1) the length of Phase I, (2) the assumed interest rate ("AIR"), (3) the payment mode (monthly, quarterly, *etc.*), and (4) which of two methods will be used to reflect ongoing investment performance of the assets supporting the Contract. The first periodic payment is determined as the product of the account value and an annuity factor divided by 1,000. The annuity factor is based on the age and gender of the annuitant, an "acceptable mortality table," and the first three factors identified above. Subsequent periodic payments during Phase I are calculated differently depending upon which alternative the owner chose for item (4) above.

Under one alternative, each subsequent periodic payment is adjusted to reflect the then-current account balance in relation to the AIR (*e.g.*, if payments are made monthly, they can vary in amount from month-to-month). Under the other alternative, periodic payments remain level throughout the year but are adjusted once per year to reflect the then-current account value in relation to the AIR. Irrespective of the alternative chosen, periodic payments during Phase I are calculated using the same basic formula—the account value multiplied by an annuity factor and divided by 1,000.

The ruling states that the taxpayer's method of using the account balance in calculating periodic payments during Phase I "differs somewhat in form from the method more traditionally used to calculate variable annuity payments, commonly described as an 'annuity unit' approach." However, the ruling states that the taxpayer's methodology is "based on the same actuarial principles as an annuity unit methodology and is actuarially indistinguishable from such a methodology." In that regard, the ruling states that the taxpayer illustrated that its methodology yields payments that fluctuate in "exactly the same manner as if the annuity unit methodology were used."

During Phase II, periodic payments based on the variable sub-accounts supporting the Contract are determined using the more traditional "annuity unit" methodology, and payments based on the taxpayer's fixed account are determined using an "actuarially equivalent methodology." In that regard, the ruling states that "[d]espite the differences in form with respect to the way the periodic payments are calculated during Phase I and Phase II, all of the methodologies … are actuarially equivalent to one another."

Analysis and Conclusion of PLR 200818018

Based on the foregoing facts, the taxpayer requested a ruling that the Contract constitutes an immediate annuity within the meaning of section 72(u)(4). As described above, that section defines an immediate annuity as an annuity (1) that is purchased with a single premium or annuity consideration, (2) the annuity starting date

of which commences within a year of purchase, and (3) provides for a series of SEPPs to be made at least annually. The taxpayer represented that the Contract met the first two requirements. Thus, the issue on which the Service focused in analyzing the requested ruling was whether the Contract provides for a series of SEPPs for purposes of section 72(u)(4).

The Service concluded that the Contract constitutes an immediate annuity. In reaching this conclusion, the Service noted that Congress provided little guidance on what constitutes a series of SEPPs for purposes of section 72(u)(4), but then acknowledged that the same term is used in sections 72(q) and (t) and cited to the legislative histories of those sections as providing appropriate guidance for purposes of section 72(u)(4). In particular, the Service cited the 1982 legislative history of section 72(q) for the proposition that "[i]t was understood that a methodology utilized by a variable annuity under which substantially the same number of annuity units is withdrawn to make each periodic payment provided substantially equal periodic payments." The Service also observed that the Code and the various rulings by the Service "must be viewed against the backdrop of the extant actuarial methodologies for computing periodic payments."

Based on the foregoing, the Service concluded that, because the methodologies that the taxpayer would use to determine periodic payments under the Contract are the actuarial equivalent of the more traditional "annuity unit" approach discussed in the section 72(q) legislative history, the Contract should be viewed as providing SEPPs. Accordingly, because the taxpayer represented that the Contract would be purchased with a single premium or annuity consideration and its annuity starting date would commence within a year of purchase, the Contract would be viewed as an immediate annuity for purposes of section 72(u)(4). In addition, the fact that the Contract provided a minimum payment option apparently did not affect the Service's analysis or conclusions in the ruling.

Final Observations

As indicated above, PLR 200818018 is significant in that it (1) is the first private letter ruling to confirm that variable annuity payments can constitute SEPPs for purposes of section 72(u)(4), and (2) concludes that a methodology for calculating variable annuity payments that differs from, but is actuarially equivalent to, a more traditional "annuity unit" methodology can produce SEPPs. The ruling also stands for the proposition that the legislative history, and perhaps other interpretive guidance, regarding SEPPs under section 72(q) can be used in an analysis of the SEPP component of the definition of an immediate annuity under section 72(u)(4). In other words, the ruling appears to confirm that SEPPs are SEPPs, regardless of the context. These revelations, while perhaps intuitive, had not been expressed in prior guidance. For these reasons, the ruling, albeit non-precedential, is a very helpful and informative piece of guidance.

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End Notes

[1] Unless otherwise indicated, each reference to a "section" means a section of the Internal Revenue Code of 1986, as amended (the "Code").
[2] The rule denying annuity tax treatment also does not apply if the non-natural person holds the contract as an agent for a natural person. *See* section 72(u)(1).
[3] Section 72(q)(2)(I).
[4] Section 72(q)(2)(D).
[5] Section 72(t)(2)(A)(iv). There is no "immediate annuity" exception to the section 72(t) penalty tax.
[6] *See* Staff of the J. Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 658 (Comm. Print 1987). Section 72(u) was added to the Code by section 1135(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986).
[7] Pub. L. No. 100-647 § 1011A(i)(4) (1988).
[8] S. REP. NO. 100-445, at 149 (1988).
[9] *Id.* With respect to joint life annuities, the legislative history states that "[a]n annuity will not be treated as failing to satisfy the [SEPP requirement] if it is an annuity payable over the joint lives of 2 or more individuals and the amounts paid to as survivor after the death of the first annuitant are less than the amounts paid during the joint lives of the annuitants."
[10] Staff of the J. Comm. on Tax'n, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 361 (Comm. Print 1982).
[11] *Id.* at 364. As described in the text above, section 72(t) also includes an exception to its penalty tax for SEPPs made over life or life expectancy. The legislative history of that provision states that "[a] series of payments will not fail to be substantially

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equal solely because the payments vary on account of (1) certain cost of living adjustments; (2) a benefit increase provided to retired employees; (3) an adjustment due to the death of the employee's beneficiary; or (4) the cessation of a social security supplement." Staff of J. Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 712 (Comm. Print 1986).

[12] 1989-1 C.B. 662.

[13] 2002-2 C.B. 710.

[14] 2004-1 C.B. 526.

[15] A private letter ruling is issued to a particular taxpayer and can be relied upon only by that taxpayer. *See* section 6110(k)(3). However, such rulings are widely regarded as reflecting the view of the Service's National Office on the specific facts as of the time the ruling was issued.

[16] For example, Notice 89-25 required the use of a "reasonable" interest rate assumption in the SEPP methodologies it described, and taxpayers sought rulings to ensure that their assumptions would meet this general standard. A few court cases have addressed similar questions. *See*, *e.g.*, *Farley v. Comm'r,* T.C. Summary Opinion 2003-43 (April 22, 2003) (finding that certain assumed rates in the calculation of SEPPs was not reasonable).

[17] *See* PLR 9146008 (Aug. 8, 1991).

[18] *See* also PLR 9805023 (Oct. 31, 1997). The ruling was issued after PLR 9115041, and concluded that certain partial withdrawals from a deferred variable annuity contract would constitute SEPPs within the meaning of section 72(q)(2)(D). The facts of the ruling stated that the contract owner would make a separate written request for each partial withdrawal, which certainly did not establish a fixed and determinable payment stream like the one the Service concluded was necessary in PLR 9115041.

[19] *See* PLR 200113022 (Dec. 29, 2000); PLR 200115039 (Jan. 18, 2001); PLR 200118057 (Feb. 9, 2001).

Coming Later this Fall …

A *Taxing Times* Supplement on IRS Revenue Procedures Addressing Contract Corrections

On June 30, 2008 the Internal Revenue Service (IRS) released five revenue procedures which address the correction of contracts which fail to comply with IRC sections 101(f), 7702, 7702A and 817(h). These revenue procedures will be the subject of our upcoming supplement.

Learn more about:

- Rev. Proc. 2008-38 – Remediation for failure to properly account for QAB charges.
- Rev. Proc. 2008-39 – Remediation of inadvertent non-egregious MECs.
- Rev. Proc. 2008-40 – Remediation for failure to satisfy the requirements of IRC sections 101(f) or 7702.
- Rev. Proc. 2008-41 – Remediation for failure to satisfy IRC section 817(h)– diversification requirements.
- Rev. Proc. 2008-42 – Procedure for obtaining an automatic waiver for certain reasonable errors that caused failure under IRC sections 101(f) or 7702.

In addition, this supplement traces the history of contract corrections and the unique interaction between the IRS, the Treasury and the industry in working toward a solution. It also details the developments leading up to these final revenue procedures.

Separate Account Dividends Received Deduction

by Gregory L. Stephenson and Stephen Baker

The Separate Account Dividends Received Deduction (SADRD) continues to be an active topic of discussion among Treasury, the Internal Revenue Service (IRS), and industry tax professionals. Given the flurry of discussion, one might ask, "Where are we now?"

On Aug. 16, 2007, the IRS issued Rev. Rul. 2007-54, 2007-38 I.R.B. 604. As many are aware, the unprecedented position, relative to the dividends received deduction taken in this ruling, sparked near instantaneous response from industry including meetings between government and certain life insurance company tax leaders. Following various meetings, the IRS issued Rev. Rul. 2007-61, 2007-42 I.R.B. 799, on Sept. 27, 2007, which suspended Rev. Rul. 2007-54.

Rev. Rul. 2007-61 states that:

> *The Treasury Department and the Internal Revenue Service (IRS) believe it is important that the company's share and policyholders' share of net investment income be determined in a manner that effectively prevents the double benefit that otherwise would result from the use of tax favored investment income (such as dividends qualifying for the dividends received deduction) to fund the company's obligations to policyholders.*

That is, the Treasury does not want to provide life insurance companies with the ability to take a dividends received deduction for tax-favored income allocable to policyholders. This is consistent with the historic rationale behind the proration required for life insurance companies. Proration prevents the double benefit possible if tax-favored investment income is used to fund a life insurance company's obligations to policyholders, *i.e.*, a reserve is increased by tax-favored income which in turn creates a deduction for the life insurance company.

The proration methodology uses "Required Interest" to measure how much investment income is allocable to the policyholder (creditable to the reserves). Contrary to both universally accepted industry practice and all historic precedent, Rev. Rul. 2007-54 proposed a methodology to calculate proration for variable contracts using Required Interest based on the higher of Applicable Federal Interest Rate (AIFR) or the Prevailing State Assumed Interest Rate (PSAIR). This methodology change would have often resulted in a 100 percent policyholders' share and effectively eliminated the SADRD for almost all life insurance companies. Further, this methodology yields a result that has no logical relationship to the purpose of proration; measuring the amount, and only the amount, actually credited to the policyholders. For a detailed and thorough discussion of the topic please see: Bush, Richard and Stephenson, Gregory, "Separate Account DRD Under Attack: Five Decades of Practice Regarding Company Share Computation Ignored," 34 Ins. Tax Rev. 39.

As stated above, Rev. Rul. 2007-61 suspended Rev. Rul. 2007-54, and notes that the Treasury and the IRS may address in regulations the issues considered in Rev. Rul. 2007-54. (Note: As suggested in Rev. Rul. 2007-61, this has been added to the 2007-2008 Priority Guidance Plan, *see*: First Periodic Update of the 2007-2008 Priority Guidance Plan, Insurance Companies, Item 9, April 22, 2008). It also states that the Treasury and the IRS are mindful of the benefit of notice and public comment.

Walter Welsh and the American Council of Life Insurers (ACLI) joined the dialogue with government and submitted a letter to Treasury on Jan. 2, 2008, which indicates their willingness to work with the Treasury and the IRS and states that only minor modifications are needed to update the regulations to incorporate the relatively few changes resulting from the Deficit Reduction Act of 1984 (1984 Act), P. L. 98-369 (DEFRA). The submission makes several valid and compelling points.

The ACLI submission notes that while the legislative history does not specifically elaborate on Required Inter-

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est, it does specifically state that the concept of proration in current law is carried over from the provisions in prior law under which a life company's gain or loss from operations was computed. H.R. Rep. No. 432, part 2, 98th Cong. 2d Sess. 1430 (1984). Additionally, the submission underscores the fact that the legislative history requires that, where a provision from prior law is incorporated into current law, the regulations, ruling and case law under prior law shall be used as interpretive guides for current law. H.R. Rep. No. 432 at 1401; S. Prt. No. 169 at 524. Looking to TAM 200038008 (June 13, 2000), the submission points out that the existing regulations' methodology for determining Required Interest is easily applied within the confines of the 1984 Act. The formula looks to the actual investment income credited to the policyholders after company charges and expenses (the amount retained). This is the correct answer. Actual investment income credited to policyholders is the true measure of the increase in reserve deduction allowed the life insurance company. Treas. Reg. § 1.801-8(e) is still the best method of measuring any double benefit.

This submission reiterates that any published guidance issued by the Treasury and the IRS should confirm "that this long-standing current application of the law continues to govern."

On April 22, 2008, Walter Harris, Industry Director for Financial Services, issued a Memorandum for Industry Directors regarding examination of the SADRD. LSMB Control No.: LMSB-04-0308-010. The first part of the discussion provides a recap of the issue of avoiding a double benefit and references IRC § 805(a)(4)(ii) which limits the DRD to the life insurance company's share of the dividends received. The discussion then provides a brief comment about proration under § 812, followed by a summary of the concept of the difference between a separate and general account of a life insurance company. The last part of the discussion then states:

> *Under § 812(b)(2), required interest on reserves generally is determined using the greater of the prevailing State assumed interest rate (PSAIR) or the applicable Federal interest rate (AFR) if such rate is used in determining reserves for the contract. See § 812(b)(2)(A); Rev. Rul. 2003-120; 2003-2 C. B. 1154.*

This comment speaks to the development of reserves under a contract but does not address the concept of Required Interest for proration. The guidance—which acknowledges the suspension of Rev. Rul. 2007-54—ultimately appears to continue the misdirected logic of Rev. Rul. 2007-54.

The memo clearly does not encourage the computation of Required Interest under "another appropriate rate" as allowed by § 812(b). The memo contains an attached "Guideline for an Information Document Request." The guideline contains four questions. Each question focuses only on the reserves of the life insurance company and fails to address the core issue, the amount actually credited to the policyholders.

The ACLI sent a follow up submission to the Treasury and the IRS on June 26, 2008. This submission provides detailed factual background on industry developments that affect the amount of the company's share of investment income, as well as a detailed legislative history of the development of the proration rules. This thorough document establishes a strong foundation for the fact that the substantive result of the existing regulation is correct. This submission reiterates that any published guidance issued by the Treasury and the IRS should confirm "that this long-standing current application of the law continues to govern."

A thorough review of legislative and judicial history—while too broad for this article, but in summary applicable—demonstrates that the current methodology works. As Bush and Stephenson state in the above cited article, "All of the various historic methods of taxing life insurance companies have required the isolation of that portion of investment income, and only that portion, that is necessary to support the company's obligations to its policyholders, and computed this amount in a theoretically consistent manner." As far back as the Revenue Act of 1921, a portion of a life insurance company's income was excluded from taxable income since it was used to fund its obligations to its policyholders. The Life Insurance Company Tax Act of 1959 (1959 Act), P.L. 86-69, 77 Stat. 112(19) instituted a three-phase life insurance company tax and provided what is the basis of current

proration methodology. The 1959 Act also required separate accounting for the general account and the segregated asset accounts. *See* 801(g) under the 1959 Act. The 1959 Act proration methodology looks to the amount of current earnings that funds a company's obligations to its policyholders. In *Atlas Life Insurance Company*, 381 U.S. 233 (1965), the Supreme Court found that this proration methodology was proper as it adequately isolated that portion of the current earnings credited to policyholders—the only portion on which it was receiving a "double" benefit.

When Congress enacted into effect the Deficit Reduction Act of 1984, it retained the proration formula used under the 1959 Act. Despite changes to life insurance company taxation in general, the concept of policyholders share was retained. The historic concern over a double tax benefit was resolved by specifically adopting the 1959 Act proration methodology. There is no 1984 Act methodology. 39S. Prt. 169, 98th Cong., 2d Sess., at p. 557; H. Rept. 98-432 (Part 2), 98th Cong., 2d Sess., at pp. 1430-1431; Conference Report, H.R. Rep. No. 98-861, pp. 1065-1066, 1984-3 C.B. Vol. 2, p. 296; *See also,* 1984 Blue Book, at p. 623.

While the above is a very broad overview, it underscores the fact that the proration concept from 1921 forward is historically consistent and uniformly isolates that portion, and only that portion, of investment income necessary to support a company's obligation to its policyholders. This very basic concept has been approved by the courts, Congress and, prior to Rev. Rul. 2007-54, by the IRS (*See* TAM 200339049, Aug. 20, 2002 and TAM 200038008, June 13, 2000).

Many companies continue to be forced to deal with this issue despite the suspension of Rev. Rul. 2007-54 as many agents are still being directed to pursue the flawed methodology first set out in this suspended ruling. While the Treasury and the IRS are to be commended for their prompt action in issuing Rev. Rul. 2007-61, one can only hope that soon the field will abide by its directive that, until any regulatory guidance is issued, "the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued." As the mandate of the Code, the Regulation, 87 years of consistent precedent, and indeed the IRS prior to this suspended ruling, are all in agreement, the 1959 Act proration methodology should be applied. ◂

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TECHNICAL TAX EXPERTISE NEEDED FOR E3

E3 refers to the Society of Actuaries' system of Education, Examination and e-Learning. To provide technical expertise with regard to E3, the SOA has appointed E3 liaisons from each Special Interest Section. Peter Marion, a Taxation Section Council Member and the Section's Education Representative, has agreed to serve as the Taxation Section's E3 liaison.

Volunteers with technical tax expertise are needed to support this effort. Long-term and short-term opportunities include:

Long-term:
- Independent review of syllabus choices.
- Direction for future syllabus changes.

Short-term:
- Expert review of exam questions.
- Grading outlines.

If you are interested in using your technical tax expertise to assist the E3 activities, please contact Peter Marion at *peter.marion@sunlife.com*.

The Tax Reserve Method Should Be PBR Once It Is Adopted by the NAIC

by Peter H. Winslow

Notice 2008-18[1] outlines tax issues and concerns of Treasury and the Internal Revenue Service (IRS) in the event the National Association of Insurance Commissioners (NAIC) adopts AG VACARVM and/or principle-based reserves (PBR). Comments on the Notice were filed by the American Council of Life Insurers (ACLI), the NAIC and the American Academy of Actuaries (AAA). One of the questions in Notice 2008-18 addressed by the ACLI relates to whether Treasury and the IRS are required by the Internal Revenue Code to accept AG VACARVM and PBR as the tax reserve methods under I.R.C. § 807(d). Specifically, the Notice asks:

> *. . . if Proposed AG VACARVM and Proposed Life PBR are characterized as CARVM or CRVM, respectively, for regulatory purposes, could the Treasury Department and IRS nevertheless conclude they do not constitute CARVM or CRVM as Congress envisioned those terms to apply in 1984; alternatively, if Proposed AG VACARVM and Proposed Life PBR were not characterized as CARVM or CRVM, respectively, for purposes of applying section 807, could Proposed AG VACARVM and Proposed Life PBR nonetheless be required as the appropriate tax reserve method under the authority of section 807(d)(3)(A)(iv).*

As to the first question, the ACLI responded that, by enacting I.R.C. § 807(d), Congress deferred to the NAIC to determine the tax reserve method and contemplated that the method could be changed from time to time. As to the second question, the ACLI pointed out that it is rhetorical because the Code defers to the applicable NAIC reserve method regardless of how it is labeled. Because the ACLI's comments are somewhat conclusory, it may be useful to provide more detailed background to demonstrate why the trade association correctly summarized the law.

What is the "Tax Reserve Method?"

I.R.C. § 807(d)(3)(A) provides a general rule that the "tax reserve method" for a life insurance contract is CRVM and for an annuity contract is CARVM. CRVM and CARVM are further defined in I.R.C. § 807(d)(3)(B) to mean CRVM and CARVM prescribed by the NAIC which is in effect on the date of the issuance of the contract. This general rule applies only to contracts covered by CRVM or CARVM.[2] Thus, for example, the general rule does not apply under current law to certain group contracts for which the Standard Valuation Law does not prescribe CRVM or CARVM. For contracts that are not covered by CRVM or CARVM, one of two rules applies under I.R.C. § 807(d)(3)(A)(iv). The reserve method prescribed by the NAIC which covers the contract at the date of issue is required to be used, or, if no reserve method has been prescribed by the NAIC, a reserve method consistent with CRVM or CARVM must be used.

Under the literal language of I.R.C. § 807(d)(3), AG VACARVM and PBR should become the prescribed reserve method for tax purposes whether or not they are labeled "CARVM" and "CRVM," respectively. The statutory language defers to the NAIC's prescribed method in all cases as long as the method is designed to determine an appropriate level of insurance reserves held for policy benefits. Congress' legislative purpose in this deference to the NAIC was three-fold: (1) to provide a level playing field to ensure that all taxpayers use a uniform reserve method regardless of state-by-state variations in reserve requirements; (2) to provide a dynamic rule that would permit appropriate updates and clarification of the reserve methodology without the need to amend the statute; and (3) to provide a general rule that tax reserves would be computed using the reserve methodology for minimum statutory reserves prescribed by the Standard Valuation Law.

The questions in Notice 2008-18 may have been prompted by the suggestion of some commentators that, despite the literal language of the statute, PBR is so different from CRVM that it may not qualify as a valid tax reserve meth-

od under I.R.C. § 807(d) regardless of how it is labeled. A so-called "Cambridge Doctrine" has sometimes been relied upon as the basis for this conclusion.

Tax cases generally do not refer to a "Cambridge Doctrine." The phrase appears to have been coined by the IRS in rulings primarily dealing with qualification of a taxpayer as a tax-exempt organization, and refers to a Supreme Court case[3] that dealt with a principle of statutory construction summarized by the IRS as follows:

> *It is a long-standing principle of statutory construction that, in using a combination of definitional and popular-name descriptions to designate the various exempt organizations, Congress is presumed to have employed those terms according to their legal significance at the time of the enactment of the particular provisions in which they are used.*[4]

A strict application of this principle of statutory construction could lead to the conclusion that Congress can be presumed to have intended that tax reserves be computed using CRVM and CARVM, or a variation thereof, as they were understood as of the time they were added to the Code in the Deficit Reduction Act of 1984. The problem with this conclusion is that it ignores a second, more relevant, aspect of the Supreme Court's decision in *Cambridge* that applies where the scope of deference to state law in a federal tax statute is at issue. In deciding whether the taxpayer in *Cambridge* qualified for tax-exempt status as a "domestic building and loan association," the Court noted that this term was commonly understood under state law to mean a society that raises funds by subscriptions of its members in order to enable a member to borrow on an amount of security equal to the member's subscription to build or buy a house. The government argued that the taxpayer did not qualify for tax-exempt status because it lent money to non-members out of proportion to the borrowing needs of its members and to members in excess of their subscriptions. State law of the taxpayer's state permitted these activities and other states also permitted them to varying degrees.

The Supreme Court first noted that in granting the tax exemption Congress "was speaking of existing societies that commonly were known as such." Nevertheless, it gave considerable deference to state law because building and loan associations were a creation of the states and because the statute referred to "domestic" societies. It concluded that the taxpayer qualified for tax-exempt status, deferring to the state law definition "unless there is a gross misuse of the name." The Court noted that a

A strict application of this principle of statutory construction could lead to the conclusion that Congress can be presumed to have intended that tax reserves be computed using CRVM and CARVM. ...

state's designation of an entity as a building and loan association is not absolute and will not apply in "extravagant cases." But, deference nevertheless was justified because a "State is not likely to be party to a scheme to enable a private company to avoid federal taxation by giving it a false name."

Because the I.R.C. § 807 reserve rule is similar to deference to state law (actually, deference is to an association of state representatives), it is the "gross misuse" standard of *Cambridge* that is more relevant than the broader "Cambridge Doctrine" applied by the IRS in its tax-exemption rulings. Moreover, for reasons described below, even the "gross misuse" standard may not apply when applying I.R.C. § 807 to PBR.

Deference to State Law in Federal Tax Statutes

Congress' intent in enacting the Internal Revenue Code was to provide a system of taxation that applies equally to taxpayers in all states.[5] In recognition of this intention, the Supreme Court in *Burnet*[6] held that federal tax legislation, "in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation." It stated further: "state law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." A District Court decision[7] provides a useful summary of the relationship of state law to federal tax law:

> *The guiding yardstick I extract from these cases is that in respect of general words of common usage, words which Congress would necessarily use to express a broad principle rather than a specific transaction, federal law should control without reference to nuances of local color. On the other hand, recognizing that Congress did not intend the tax law to establish a superseding code of primary relationships, the use of words of art which by their nature require reference to specific definitional or*

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applicative elaboration in order to take on meaning mandates reference to state law.

As a factor in determining whether state or federal law should apply, the label used in the Code can point to state law where the label is a reliable indicator of specific legal and economic consequences under state law. For instance, in order to determine the attributes of a "corporation" or a "partnership" for federal tax purposes, it is necessary to go behind the labels and look to state law to determine the underlying legal relationships of the parties.[8]

Because of a desire for uniform taxation, it is relatively rare for Congress to defer expressly to state law to determine taxation. Therefore, as in *Cambridge,* the dispute usually is whether Congress has deferred to state law implicitly in its adoption of a state law definition. In these cases, courts have sometimes relied on the "gross misuse" standard of *Cambridge* when Congress used a term of art having a well-recognized meaning under state law. For example, the gross misuse standard was used in one case[9] to conclude that the taxpayer qualified as an insurance company for tax purposes.[10] The "gross misuse" standard of *Cambridge* does not apply where a familiar state law term is used in the Code, but the Code also contains a clarifying definition.[11]

To summarize, some basic principles can be gleaned from these cases:

- Congress desired to have a nationwide uniform system of taxation; therefore, although state law governs legal rights, federal law determines how they are taxed.
- Terms of art used in a statute generally will be interpreted according to their common usages; Congress will be presumed to have intended that the common usage of a statutory term will be interpreted in a manner consistent with Congress' intent at the time the statutory language was enacted.
- Where Congress has adopted a state law definition in the Code, and otherwise by clear implication has demonstrated an intent for the state law definition to apply, changes in state law will govern, and state-by-state variations will be respected, unless there is "gross misuse."
- When the Code has an express statement that state law controls, state law, in fact, does control.

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Application of Principles to AG VACARVM and PBR Under I.R.C. § 807(d)

Under the case law, it appears that AG VACARVM and PBR should qualify as the tax reserve methods under I.R.C. § 807(d) once they are prescribed by the NAIC regardless of how they are labeled, as long as the NAIC has made clear that the reserves are intended to provide for future insurance benefits under the contracts. The following factors support this conclusion.

- I.R.C. § 807(d) contains an express deference to the NAIC method and the wording of the statute indicates an intent that the NAIC method will continue to govern in the event the NAIC-prescribed reserve method is changed.
- Congress' concern of state-by-state variances if state law governed the federal tax law outcome is not present for PBR because deference to the NAIC provides a uniform rule.
- Because of the high degree of state regulation of insurance companies, and of reserves in particular, the risk of "gross misuse" is minimal.
- AG VACARVM and PBR are consistent with one of Congress' legislative purposes in enacting and later amending I.R.C. § 807(d) – to achieve more economic tax reserves.

Of course, a conclusion that AG VACARM and PBR will become the tax reserve methods does not mean that the resulting reserve amounts will be adopted for tax purposes without adjustments. As with CRVM and CARVM, any new tax reserve method adopted by the NAIC will have to run the gamut of I.R.C. § 807(d) and § 811 to arrive at the appropriate level of tax reserves.

End Notes

1 2008-5 I.R.B. 363.
2 I.R.C. § 807(d)(3)(A).
3 *United States v. Cambridge Loan & Bldg. Co.*, 278 U.S. 55 (1928).
4 G.C.M. 37325 (Nov. 18, 1977), underlying Rev. Rul. 79-128, 1979-1 C.B. 197.
5 *Burnet v. Harmel,* 287 U.S. 103 (1932).
6 *Id.* at 110.
7 *Weir Foundation v. United States*, 362 F. Supp. 928, 935 (S.D. N.Y. 1973), *aff'd*, 508 F.2d 894 (2d Cir. 1974).
8 *See Morrissey v. Commissioner,* 296 U.S. 344, 360 (1935).
9 *Home Title Ins. Co. v. United States,* 50 F.2d 67, 111 (2d Cir. 1931).
10 *See La Caisse Populaire Ste. Maria v. United States*, 563 F.2d 505 (1st Cir. 1977), and *Barnett Banks, Inc. v. Commissioner*, T.C. Memo. 2002-168, for more recent applications of the aspect of the *Cambridge* case dealing with deference to state law.
11 *Mutual Savings & Loan Co. v. Commissioner*, 44 B.T.A. 1204 (1941).

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SESSION 63	Tuesday, October 21	8:30 – 10:00 a.m.

Federal Income Tax Implication of Principle-Based Reserves

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Earlier this year, the IRS and Treasury weighed in with their view of the tax implications of PBR. Come to this session to learn where the current tax pressure points are, and what is being done by the industry and the actuarial profession to address the Treasury concerns.

SESSION 105	Wednesday, October 22	9:00 – 10:15 a.m.

Tax Treatments and Traps – Life Products and Their Usage

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What unique product tax issues are the industry experts wrestling with this year, and how should they be affecting your company's product and marketing strategy? In this session you will learn about two hot product tax topics and have the opportunity to ask questions of the experts.

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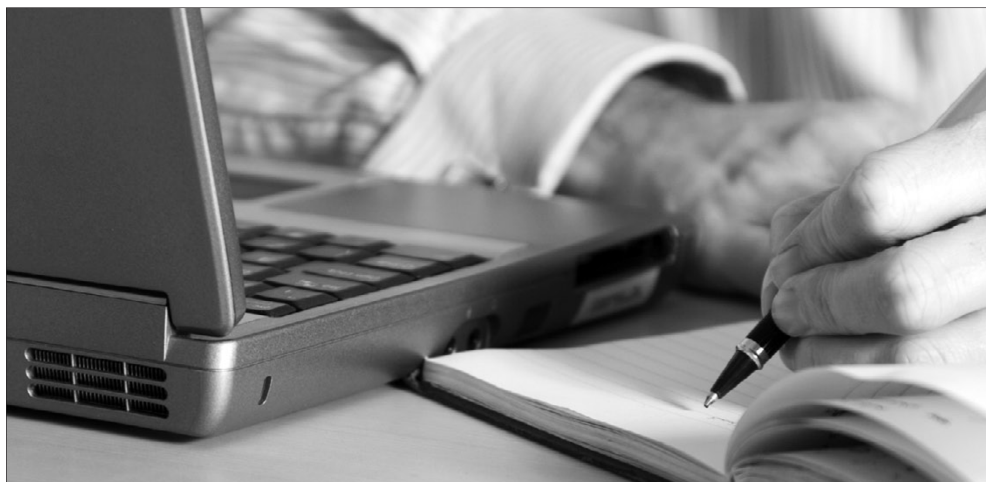
Tax Aspects of Nonperforming Assets

by Samuel A. Mitchell and Peter H. Winslow



The recent turmoil in the financial markets has sparked a renewed interest in the tax rules covering nonperforming assets. For insurance companies, the rules take on added significance because of the interplay between statutory accounting and tax. This is an appropriate time for a brief review and comparison of the statutory and tax accounting rules.

Accrual of Investment Income

On the investment income side, SSAP No. 34 requires a two-step process for the accrual of income when collection is in doubt. First, investment income must be written off if it is probable that it will not be collected. The "probable" standard is derived from SSAP No. 5. As used in SSAP No. 5, "probable" refers to "that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." (SSAP No. 5, fn. 1.) Second, SSAP No. 34 requires that investment income over 90 days (or 180 days for mortgages) past due must be treated as a non-admitted asset on the balance sheet. Because the second step has no effect on income, the relevant standard for comparison with the tax rules is the "probable" standard under the first step.

How does the "probable" standard compare with the tax standard for accrual of income? For income tax purposes, Treas. Reg. § 1.451-1(a) applies the accrual method to interest income, requiring an income inclusion when all events have occurred that fix the right to receive the interest income and the amount can be determined with reasonable accuracy. The accrual standard for the income inclusion is satisfied when the interest is economically earned, payment is due or payment is received.[1] An exception applies, however, if there is a "reasonable doubt as to collectibility" at the time the accrual standard otherwise would be satisfied.[2] The "reasonable doubt as to collectibility" standard is a lesser standard than the wholly worthless standard for the write-off of principal discussed below. Although there is little or no guidance comparing the statutory and tax standards, the Internal Revenue Service (IRS) can be expected to apply the "reasonable doubt as to collectibility" standard in a more stringent manner than the statutory accounting "probable" standard. In Rev. Rul. 2007-32,[3] applicable to banks, the IRS strictly construed the exception from accrual, holding that the uncertainty as to collection must be "substantial." The IRS also reiterated case law providing that a temporary financial difficulty of the debtor is not sufficient to avoid accrual of income and that it is the taxpayer's burden to demonstrate substantial uncertainty as to collection. Thus, it is up to the taxpayer to accumulate and preserve the evidence regarding the debtor's financial instability to substantiate the nonaccrual of interest and avoid an IRS audit adjustment. Furthermore, the IRS appears to have designated this as a Tier II issue under its Issue Focus Program, meaning that the issue may draw increased attention and some level of coordination from the IRS National Office.[4]

It is unclear how these write-off rules apply in the case of original issue discount (OID). The IRS has taken the position in a Technical Advice Memorandum (TAM) that the "reasonable doubt as to collectibility" standard does not apply to OID income inclusions under I.R.C. § 1272.[5] According to the IRS, OID accruals cannot be written off until the underlying debt instrument meets the worthlessness standard. This result is adverse in terms of the timing and characterization of the loss. The timing is delayed and the loss effectively is converted to a capital loss, which cannot be offset against ordinary income. The capital/ordinary income mismatch potentially could be a significant problem for taxpayers with large losses resulting from the credit crisis and is a hot topic among tax professionals who specialize in financial products taxation. However, there is a question as to whether the TAM result applies to life insurance companies. Under I.R.C. § 811, life insurance companies apply statutory accounting rules for bond premium and OID accruals. So, arguably there should be no OID accrual for tax purposes when it has stopped on the annual statement.[6]

On the tax planning side, it is important to invoke non-accrual of interest because, once income has been accrued, it can only be written off when the debt becomes worthless—a much more difficult standard to satisfy (discussed below).

Write-down of Principal

Like the nonaccrual of investment income, recognition of loss in the principal of an investment in statutory accounting is governed by a "probable" standard. However, measurement of the loss is determined using a fair value standard. SSAP No. 26 contains the statutory accounting rules for bonds, except for loan-backed securities, structured securities and partnerships, joint ventures and LLCs (*see* SSAP Nos. 43 and 48). Under SSAP No. 26, if the decline in the value of a bond is not temporary, the cost basis in the bond is written down to fair value and a loss is realized. Impairment is deemed to occur if (1) noncollection of a portion of the debt is "probable" or (2) a decision is made to sell at a loss before maturity. SSAP No. 36 contains the statutory accounting rules for troubled debt restructurings. Once again, the "probable" standard derived from SSAP No. 5 applies here. The transfer of assets to creditors is accounted for at fair value, as are modifications of the debt. If fair value is less than book value, a loss is realized. SSAP No. 37 applies to mortgage loans. Impairment occurs when it is probable the company will be unable to collect all amounts due, including interest. Again, the familiar SSAP No. 5 "probable" standard applies here. If the impairment standard is met, there is a write-down to fair value measured by the collateral (less the estimated costs to obtain and sell the collateral). If interest is 180 days past due, but collectible, it is accrued on the balance sheet as a non-admitted asset.

The comparison with tax standards is a little more complex for principal write-downs than for non-accrual of interest income. Differences between statutory and tax standards can occur not only in the timing of recognition of the loss, but also in the measurement of the loss and in its character.

For tax purposes, there are two general types of write-downs for principal. The first and most common is a worthless security deduction under I.R.C. § 165(g). That section allows a capital loss for the basis of the debt instrument if it is a "security." A security is defined as a stock, subscription right or bond, debenture, note or certificate or other evidence of indebtedness with interest coupons or in registered form. Treas. Reg. § 5f.103-1(c)(1) defines registered form. According to the regulation, an obligation is in registered form if the debt may be transferred only through a book entry system maintained by the issuer or if the obligation is registered with the issuer as to both principal and any stated interest and any transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder. As a general rule of thumb, corporate bonds, and anything subject to a public offering, are securities. Investments that do not belong in the "securities" basket may include private placements, individual mortgages and partnership interests.

Classification of the investment as a security is a disadvantage for purposes of a tax write-down because the security must be wholly worthless to qualify for a loss. Treas. Reg. § 1.165-4(a) provides that a deduction cannot be taken for a mere decline in value of the security. A security is worthless if a reasonable person in the exercise of sound business judgment would regard collection as hopeless. The investment is not worthless if there is a liquidation value or the possibility of future recovery. For tax planning purposes, if an instrument that is a security subject to I.R.C. § 165(g) has a large embedded loss but is not completely worthless, the holder should consider selling or abandoning the instrument to trigger a loss deduction.

As a general rule of thumb, corporate bonds, and anything subject to a public offering, are securities. Investments that do not belong in the "securities" basket may include private placements, individual mortgages and partnership interests.

The second general type of write-down for an impaired asset is a bad debt deduction under I.R.C. § 166 applicable to a worthless debt that is not a security subject to I.R.C. § 165(g). The character of a bad debt deduction is ordinary, rather than capital, as in the case of a worthless security. The taxpayer can claim a bad debt deduction either when the debt is wholly worthless or can claim a partial bad debt deduction. To claim a deduction for a partial bad debt, the taxpayer must charge off the value on its books and records.

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The deduction for partial worthlessness is subject to the same hopelessness standard as the wholly worthless standard. This creates a problem because the portion of principal that actually is worthless frequently is less than the statutory write-down to fair value. Therefore, a claim for partial worthlessness can involve a book/tax difference. It is possible, however, to avoid this result under special bad debt rules. Banks and certain other regulated companies enjoy a conclusive presumption of worthlessness based on the charge-offs on their books and records. The conclusive presumption, found in Treas. Reg. § 1.166-2(d), applies to a charge-off of principal or accrued interest[7] that the regulatory agency orders for charge-offs made under established policies and procedures that the agency confirms in writing in its first audit of the taxpayer after the charge-off. The presumption applies to banks or other corporations that are subject to supervision by federal authorities or state authorities that maintain substantially equivalent standards. Some IRS agents have taken the position on audit that the presumption does not apply to insurance companies even though they are regulated. In one unreported case, however, the Court of Federal Claims held that the presumption applied to a write-off of a reinsurance receivable, based on findings that the Ohio Department of Insurance order was in writing and that Ohio's standards for bad debts were similar to the federal banking standard.[8] For this presumption to apply, it is essential that written confirmation be obtained from the state insurance regulators that a write-off is required.

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The statutory rules for troubled debt restructurings under SSAP No. 36 are less likely to generate a book/tax difference. For tax purposes, a debt restructuring generally is treated as a sale of a capital asset, giving rise to an exchange under I.R.C. § 1001.[9] For such restructurings, tax accounting generally is equal to the statutory accounting.

Timing Issues

The differences in standards between statutory and tax accounting give rise to timing and evidentiary issues. For tax purposes, worthless securities, worthless bad debt and partial bad debt deductions that are not subject to the regulatory charge-off presumption must be taken in the year the debt or portion of debt becomes worthless. A taxpayer may have enough information to support a statutory write-down, but may not have sufficient information or documentary evidence to support the write-down under the more stringent tax standard. Therefore, taxpayers should continually monitor a write-down of principal or previously accrued interest that satisfies the statutory "probable" standard, but may be challenged under the tax standard. Where there is any question as to the year in which a worthlessness loss or bad debt deduction is allowable, we sometimes recommend that protective claims for refund be filed for any year in which it is arguable that the worthlessness occurred. Bad debt and worthless securities deductions are subject to a special seven-year statute of limitations for refund claims;[10] however, IRS agents have sometimes taken the questionable position that the seven-year statute of limitations does not apply in all cases, at least in the context of partial bad debt deductions. Therefore, taxpayers should consider filing any protective refund claims within the usual three-year statute of limitations in order to preserve their right to the deduction and to avoid an unnecessary dispute with IRS agents. ◂

End Notes

1 Rev. Rul. 74-479, 1974-2 C.B. 148.
2 *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th. Cir. 1968).
3 2007-21 I.R.B. 1278.
4 *See IRS Issues Exam Guidelines to Promote Consistency,* T^3: Taxing Times Tidbits, 33 *Taxing Times*, Vol. 3, Issue 3 (Sept. 2007). As mentioned in the earlier Tidbit, the IRS designated Nonperforming Loans as a Tier II issue and appointed an issue owner executive to coordinate examinations on the issue, but has not issued a directive. Without a directive, we cannot be certain of the scope of the issue and whether it applies outside the banking industry.
5 TAM 9538007 (June 13, 1995).
6 In a 1993 Field Service Advice, the IRS Chief Counsel's Office advised that a life insurance company was not required to accrue OID on debt instruments that were not adequately secured by the underlying real estate collateral provided that the company's accounting treatment was consistent with NAIC standards. FSA 460, 1993 WL 1469687 (IRS FSA).
7 Rev. Rul. 2007-32, *supra*, holds that the presumption applies to accrued interest as well as principal.
8 *See Credit Life Ins. Co. v. United States*, 948 F.2d 723 (Fed. Cir. 1991), at fn 3, where the appeals court referred to the lower court's unpublished finding.
9 In *Cottage Savings Ass'n v. United States*, 499 U.S. 554 (1991), the Supreme Court held that a material change in entitlements under a contract resulted in an exchange. Following this rule, the regulations under I.R.C. § 1001 provide that significant modifications result in a deemed sale. Treas. Reg. § 1.1001-3(b).
10 The normal statute of limitations for tax paid with a return is three years from the date of the filing of the return, subject to mutually agreed-to extensions of the three-year period to assess the tax and file claim refunds. See I.R.C. § 6511(b)(2). I.R.C. § 6511(d) extends the basic deadline to seven years for worthless securities and bad debt deductions.

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ACLI Update Column

by Bill Elwell and Mandana Parsazad

In past issues of *Taxing Times*, American Council of Life Insurers (ACLI) and others have discussed: (1) the significance of the Treasury Department's Notice 2008-18, regarding NAIC reserve modernization efforts (a) proposed Actuarial Guideline VACARVM (AG VACARVM) and (b) a proposed principle-based approach for calculating statutory reserves for life insurance contracts (Life PBR); and (2) the joint efforts of industry and the Internal Revenue Service (IRS) regarding life and annuity contract correction procedures. This update column discusses the status of both these projects and reports on one other development of interest concerning statutory reserves.

AG VACARVM and Life PBR

In the February 2008 issue of *Taxing Times*, we discussed the anticipated Treasury Notice, which the Treasury subsequently released as Notice 2008-18. The Treasury issued this Notice to alert life insurance companies to potential federal income tax issues surrounding the adoption of the proposed AG VACARVM or Life PBR. In May 2008, ACLI, the American Academy of Actuaries (AAA), and the National Association of Insurance Commissioners (NAIC) each submitted a comment letter to the Treasury responding to the Notice. Each of these letters focused on different aspects of the Notice.

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ACLI Comment Letter

ACLI's letter focused on AG VACARVM, first because the NAIC's project to modernize the reserving methodology for variable annuities is farther along in its development than the NAIC's effort to modernize the reserving methodology for life insurance contracts. ACLI's comments: (1) address the definition of "life insurance reserves" under section 816(b); (2) address the reserve prescribed by section 807(d) first with respect to the standard scenario and then with respect to the stochastic portion of the reserve; (3) discuss the effect of designation of the new methodologies as CRVM or CARVM; and (4) provide updated information on the status of efforts to model the methodological changes and on the timetable for adoption of AG VACARVM. ACLI plans to submit additional comments addressing Life PBR and other issues addressed in Notice 2008-18. Among the points we anticipate addressing in those comments will be the questions regarding the effect of the annual revision of certain parameters and assumptions used in the calculation of the reserves.

Academy Comment Letter

The Academy's comments addressed five topic areas related to Life PBR issues that the Notice raises as concerns: (1) constraints on setting assumptions for principle-based reserves; (2) why a provision for uncertainty is included in reserves; (3) discussion of the gross premium valuation method; (4) determination of mortality assumptions; and (5) auditing principle-based reserves.

NAIC Comment Letter

NAIC's comment letter provided background information on the NAIC and its processes to coordinate and oversee the development of a principle-based approach for reserving. The letter explains that the NAIC is fundamentally interested in the financial solvency of the insurance companies that it regulates, and describes the Life PBR and AG VACARVM modernization projects as moving away from a formulaic reserve—which accounts for some specific prescribed risks—to a reserve process based on actuarial principles that consider all identifiable and quantifiable material risks.

All parties expressed appreciation in their respective comment letters for the Treasury's efforts in issuing this Notice and an interest in continuing the dialogue with the Treasury and other interested parties as the proposals develop.

Contract Corrections

In May 2008, drafts of the long–awaited revenue procedures on correction of life insurance and annuity contracts that have failed to meet the requirements of sections 7702, 7702A, or 817(h) of the Internal Revenue Code were made available to the public on the Office of Management and Budget's Web site. These draft revenue procedures are in response to industry comments to Notice 2007-15 on how contract corrections procedures for life insurance and annuity contracts can be simplified and streamlined. We understand that the Treasury and the IRS intend to issue these revenue procedures in final form soon.

We reported in the May 2008 issue of *Taxing Times* that the Treasury and the IRS took an unusual and favorable step and provided us with an outline of the guidance they were contemplating in January of this year. In keeping with our continued open dialogue, the Treasury and the IRS invited industry input on the draft revenue

procedures. In June, ACLI submitted a brief comment letter that we hope will assist the Treasury and the IRS in further refining certain points in this comprehensive guidance project for the industry. ACLI would like to reiterate its appreciation for the efforts that the Treasury and the IRS representatives have devoted to this project; the fruits of their labor in this guidance project are evident and commendable.

Multiple Annual Statements

The Treasury and the IRS were working on a project concerning the meaning of the term statutory reserves under section 807 when the insurance company is subject to different statutory requirements in different states this past fiscal year. ACLI submitted a comment letter to the Treasury and the IRS on May 20, 2008, with a recommendation that this proposed revenue ruling reconfirm the well-settled meaning of the term "statutory reserves" in section 807 of the Internal Revenue Code. We noted that the Treasury regulations have long contained a provision that provides discretion to the taxpayer to select the annual statement that reflects the highest aggregate reserve in any state or jurisdiction in which it transacts business.

ACLI suggested that if the Treasury and the IRS were contemplating a change in the long-standing rule found in the regulations as part of this revenue ruling project, such a change should be in the form of a proposed amendment to current regulations and not as a revenue rule. We noted that this approach would provide notice and opportunity for taxpayers to comment, and would afford opportunity for appropriate transition rules to reflect the changes in computing reserves that may result from the adoption of a new rule.

The IRS completed this project by releasing Rev. Rul. 2008-37, on June 27, 2008. The ruling adopts ACLI's position, confirming the current rule in the Treasury regulations that permits taxpayers to choose the highest aggregate reserve in any state in which it conducts business.

ACLI and its members were concerned about the issuance of a revenue ruling that would have retroactively changed the current rule in the regulations. We appreciate the fact that the Treasury and the IRS were responsive to the industry's concerns and reached the correct conclusion on process as well as substance in this project. ◂

Editor's Note Regarding Contract Corrections

On June 30, 2008, the Internal Revenue Service (IRS) released in final form the five revenue procedures which address the correction of contracts which fail to comply with IRC sections 101(f), 7702, 7702A and 817(h). These revenue procedures are: Rev. Proc. 2008-38 – Remediation for failure to properly account for QAB charges, Rev. Proc. 2008-39 – Remediation of inadvertent non-egregious MECs, Rev. Proc. 2008-40 – Remediation for failure to satisfy the requirements of IRC sections 101(f) or 7702, Rev. Proc. 2008-41 – Remediation for failure to satisfy IRC section 817(h) – diversification requirements and Rev. Proc. 2008-42 – Procedure for obtaining an automatic waiver for certain reasonable errors that caused failure under IRC sections 101(f) or 7702. These revenue procedures will be addressed in detail in an upcoming *Taxing Times* supplement.

SOA Releases Financial Reporting for Insurance Contracts under Possible Future International Accounting Standards Report

PricewaterhouseCoopers and the Society of Actuaries' Project Oversight Group have completed this study, examining the impact of the International Accounting Standard Board's (IASB's) tentative conclusions on international financial reporting standards for insurance products.

View the report by going to *www.soa.org*, and clicking on "Research," "Research Projects," and "Life."

T3: Taxing Times Tidbits

Proposed IASB Discussion Paper Accounting Standard for Insurance—Back to the Future

by Peter H. Winslow

In May 2007, the International Accounting Standards Board (IASB) issued a discussion paper entitled "Preliminary Views on Insurance Contracts." The discussion paper proposes a new accounting model applicable to all insurance contracts including life and non-life. The model for insurance reserve liabilities is "current exit value" (CEV), where CEV is defined as the amount that an insurer would expect to pay to transfer its remaining contractual rights and obligations to another entity. This amount is determined by three building blocks: (1) a probability-weighted best estimate of future cash flows; (2) which is discounted for the time value of money; and (3) to which is added an explicit margin to compensate a potential purchaser for assuming the risk. Remarkably, there is history for a similar market-based approach to reserving in U.S. regulation of property/casualty companies and in the tax law dealing with unearned premium reserves.

The concept of unearned premiums found its origin in the fire insurance business in New York. The comptroller of New York inserted in the 1858 Fire Annual Statement blank a liability item for the "Amount required to safely reinsure all outstanding risks, estimated by the President and Secretary." This liability was later identified as an "unearned premium reserve" in the New York Insurance Law. The primary purpose of the unearned premium reserve was to assure the continuance of coverage in the event the company became insolvent. Insolvency was a particular risk for fire insurers in the mid-1800s due to the predominance of wooden construction and spotty fire protection. As exposure to catastrophic losses from fire lessened and the availability of reinsurance increased, the concept of unearned premium reserves evolved from its original reinsurance-value concept to either the appropriate amount that would be returned to policyholders if the insurer canceled all its policies or the unearned portion of the premium on the unexpired risks under existing policies. Life insurance reserves never followed a similar evolution. At the same time the New York comptroller adopted the original definition of unearned premium reserves, Elizur Wright in Massachusetts was developing a formulaic net premium valuation method which ultimately became the model for the Standard Valuation Law adopted 90 years later.

Interestingly, the history of unearned premium reserves as a market-based liability has been recognized in the case law in at least one tax case. The Tax Court[1] noted that the reserves for unearned premiums historically included amounts needed for reinsurance in the event of insolvency:

> *The term "unearned premium" is entirely a term of insurance art and can be understood only by reference to industry practice and history. The "unearned premium reserve" (in the words of the Code "unearned premiums on outstanding business") grew up historically as a reserve for insolvency reinsurance, i.e., as the amount required to be set aside out of premiums to compensate some reinsurer if, in the event of insolvency, it should be necessary for the reinsurer to undertake fulfillment of the original insurer's obligations to policyholders for periods subsequent to the date of reinsurance.*

On the basis of this history, the Tax Court concluded that reserves for retrospective rate credits and premium

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[1] *Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58, 81 (1971), acq. 1973-2 C.B. 1.

discounts are deductible as unearned premium reserves because they are the kind of obligations for which a reinsurer would require compensation if it were to take over the future obligations.

Although the CEV model for insurance reserves in the IASB discussion paper may seem new, we may just be going back to our insurance regulatory and tax roots.

Internal Revenue Service Notice 2008-42 Modifications of Split-Dollar Life Insurance Arrangements

by Gary Lee

On March 28, 2008, the Internal Revenue Service issued Notice 2008-42, which is related to modifications made to split-dollar life insurance arrangements. The Notice addresses when an otherwise grandfathered arrangement under IRC §§ 101(j) or 264(f) is treated as a new arrangement for purposes of IRC §§ 101(j) or 264(f).

IRC § 101(j) requires companies to satisfy certain notice and consent requirements when the employer purchases life insurance on the lives of certain employees. If the rules are not satisfied, life insurance proceeds that would otherwise be received tax free upon the death of the employee are taxable income to the extent those proceeds exceed the employer's basis in the policy. In general, the rules apply to policies purchased after Aug. 17, 2006, or to policies issued prior to that date if there is a material change in the contract.

IRC § 264(f) requires taxpayers to reduce their interest expense deduction to the extent the expense is allocable to unborrowed policy cash values that they own on the lives of specified individuals. In general, the rules apply to policies issued after June 8, 1997, or to policies issued prior to that date if there is a material change in the contract.

Notice 2008-42 provides that changes to split-dollar arrangements will not affect the grandfather status of policies purchased prior to the respective effective dates under § 101(j) or § 264(f) if there is no change to the underlying life insurance contract, even if the change is treated as a material modification for purposes of the split-dollar regulations. Thus, a change may be made regarding the terms of the split-dollar arrangement so long as no change is made to the life insurance policy funding the arrangement without jeopardizing the grandfather status of the policy under IRC §§ 101(j) or 264(f). This distinction in treatment arises because § 101(j) and § 264(f) look to modification of the "life insurance contract," whereas the split-dollar regulations look to a modification of the "arrangement" in addressing whether or not a modification results in the loss of grandfather protection. This Notice does not change the income, employment, self-employment, or gift tax rules provided in the split-dollar regulations effective for split-dollar arrangements entered into or materially modified after Sept. 17, 2003.

The Notice was issued in response to accounting changes for post-retiree split-dollar arrangements issued by the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board in 2006. *See* ETIF 06-04 and ETIF 06-10, which are related to endorsement and collateral assignment arrangements, respectively. In general, the ETIFs require employers to accrue post-retiree split-dollar benefits during a retiree's working years. Such treatment creates an increase in liabilities, reduces net worth and increases the debt-to-equity ratio. In some sectors, such as banking, the requirement could impact the bank's ability to satisfy capital and reserving regulations. Companies can now modify split-dollar arrangements that offer post-retiree benefits to avoid the impact of the ETIFs without subjecting grandfathered policies to the provisions of § 101(j) or § 264(f).

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Proposed Regulations Issued for New Tax Return Preparer Penalty Standards

by John Keenan

The May 2008 edition of *Taxing Times* contained an article that described recent changes relating to the new tax return preparer penalty rules under Internal Revenue Code sections 6694 and 6695, and related Code provisions, and their potential impact on the insurance industry. The return preparer penalty regime had been

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amended pursuant to legislation passed in May 2007 as part of the Small Business and Work Opportunity Act of 2007. Under the amended penalty preparer regime, the standard of care required of the return preparer is greater than the standard of care required of the taxpayer. More specifically, amended section 6694 provides that 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. Generally speaking, taxpayers can avoid a penalty if substantial authority exists for the return position for the item. This disconnect in the standard of care could create the situation in which a return preparer would require a taxpayer to disclose a tax return position—for which the taxpayer had no penalty exposure—solely to allow the return preparer to avoid a potential penalty.

Under the proposed regulations, the analysis will now focus on the person within the firm who is primarily responsible for the position taken on the return rather than the person with overall supervisor responsibility.

Notice 2008-13, published in December 2007, contained interim guidance on complying with the new section 6694 standards. (*See* John Keenan, "Impact of Tax Return Paid Preparer Penalties on the Insurance Industry," *Taxing Times*, Vol. 4, Issue 2, May 2008.). Around the time of publication, at least one proposal had been submitted in Congress to conform the standard of care required of the return preparer to the "substantial authority" standard of care required of the taxpayer reporting standard for return preparers to that which is applied to taxpayers. There have been no further developments on the legislative front.

On June 16, 2008, however, the Internal Revenue Service (IRS) issued proposed regulations on the tax return preparer penalties. The proposed regulations implement the amendments to the return preparer penalty regime passed in 2007. The proposed regulations retain the disclosure provisions originally set forth in the interim compliance rules of Notice 2008-13. Under these disclosure rules, a signing tax return preparer can, in certain instances, make a disclosure to the taxpayer rather than the IRS in order to avoid a penalty. More specifically, a taxpayer is deemed to have met the requirements of section 6694 for positions with substantial authority if the tax return preparer advises the taxpayer of all of the penalty standards applicable to the taxpayer under section 6662. The signing preparer's files must contain contemporaneous documentation that this advice was provided to the taxpayer.

Another significant change to the return preparer regime contained in the proposed regulations is the change to the "one preparer per firm" rule. Under this rule, if two or more persons with a firm were tax return preparers, ordinarily, the individual with overall supervisor responsibility for the advice given by the firm with respect to the return was considered the return preparer. Under the proposed regulations, the analysis will now focus on the person within the firm who is primarily responsible for the position taken on the return rather than the person with overall supervisor responsibility. Only one person within a firm will generally be considered the person primarily responsible for any one return position.

Other areas addressed in the proposed regulations include rules to compute the amount of the return preparer's income subject to a penalty, the ability of a preparer to rely upon information furnish by others, the reasonable belief of more likely than not standard, the definition of return preparer, and reasonable cause relief from a return preparer penalty.

A public hearing on the proposed regulations was held on Aug. 18, 2008. The IRS has indicated that it intends to finalize the regulations by the end of 2008; but the final regulations will not be applicable to returns and claims for refund filed, and advice given, before Dec. 31, 2008.

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Highest Aggregate Reserves Qualify for Statutory Reserves Cap

by Peter H. Winslow, Lori J. Jones and Samuel A. Mitchell

On June 27, 2008, the Internal Revenue Service (IRS) released Rev. Rul. 2008-37[1] dealing with the application of the statutory cap when a company conducts business in several states with different minimum reserve requirements. The IRS concludes that statutory reserves defined in I.R.C. § 807(d)(6) for purposes of the limitation on tax reserves in I.R.C. § 807(d)(1) is the highest aggregate reserve amount for I.R.C. § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve requirements of any state in which the company does business.

The revenue ruling contains two examples. In situation one, the life insurance company (IC) conducts business in 45 states and issues a life insurance contract (Contract A). IC actually holds and reports to each state insurance regulatory authority on its annual statement the highest aggregate minimum amount of reserves required for its insurance and annuity contracts under the rules of any state in which IC does business. As a result, on its 2007 annual statements, IC reported end-of-year aggregate reserves of $405,955,000 which included $9,992 of life insurance reserves with respect to Contract A.

In situation two, IC reported to each state the minimum amount of reserves required for its insurance and annuity contracts under the rules of that state. Following this principle, on its annual statement filed in State X, the state in which IC is chartered, IC reported $402,540,000 of end-of-year aggregate reserves and $9,942 allocable to Contract A. However, in its annual statement filed in State Y, IC reported $405,955,000 and included $9,992 allocable to Contract A. Thus, IC actually held and reported to at least one state the highest aggregate minimum amount of reserves required for its insurance and annuity contracts under any state in which IC does business.

The IRS concluded that in both situations, the statutory reserves as defined in I.R.C. § 807(d)(6) were $405,955,000—the highest aggregate minimum reserve amount for I.R.C. § 807(c) reserve items actually held pursuant to the minimum reserve requirements of any state in which IC does business. Therefore, for purposes of applying the statutory reserves limitation contained in the flush language of I.R.C. § 807(d)(1), the amount of statutory reserves to be taken into account with respect to Contract A is $9,992.

The revenue ruling is interesting in several respects. In a recent *Taxing Times* article,[2] we suggested that the IRS should rely on existing regulations and conclude that "statutory reserves" are the aggregate reserves reported on the annual statement included with the tax return which, at the election of the taxpayer, could be the annual statement reflecting the highest aggregate reserves in any state or jurisdiction in which it transacts business.[3] Rev. Rul. 2008-37 did not base its conclusion directly on these regulations. Instead, it appears to have concluded that statutory reserves are determined by the highest aggregate reserves in any state in which the company does business regardless of the annual statement attached to the return. If this is the correct reading of the ruling, it has several additional implications. For example, it suggests that statutory reserves can be determined by the annual statements of different states depending on which state yields the highest aggregate reserves in the particular tax year. This, in turn, implies that year-by-year changes to the statutory cap caused by changes in the applicable annual statement would not be considered changes in the basis of computing reserves subject to a ten-year spread under I.R.C. § 807(f). That is, any switch to another applicable annual statement yielding higher aggregate reserves would be a mere change in facts.

Another interesting, and somewhat puzzling, aspect of Rev. Rul. 2008-37 is its reference to the "minimum" reserve requirements of the states. In each of the examples, the taxpayer held the minimum aggregate reserves permitted by state law. The facts do not address a situation where the taxpayer holds reserves in excess of all states' minimum reserve requirements. Nevertheless, the actual holding of the ruling appears to state a broader principle than the facts. It defines statutory reserves as "the highest aggregate reserve amount for § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve re-

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[1] 2008-28 I.R.B. 77.

[2] Winslow and Mitchell, "IRS to Rule in the Meaning of Statutory Reserves," *Taxing Times* (Feb. 2008).

[3] Treas. Reg. § 1.6012-2(c); § 1.801-5(a).

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quirements of any State in which [the taxpayer] does business." This does not seem to limit statutory reserves to the actual amount of minimum reserves required; instead, it properly focuses on the amount actually reported on the annual statement in satisfaction of state law.

Rev. Rul. 2008-37 is ambiguous in at least one respect. Under I.R.C. § 807(d)(1), the comparison of the actuarially-computed federally prescribed reserve to statutory reserves generally is on a contract-by-contract basis. As a result, it is possible to read the reference to aggregate reserves in the I.R.C. § 807(d)(6) definition of statutory reserves as referring to the aggregate reserves for the contract. Although it is by no means clear, Rev. Rul. 2008-37 appears to measure statutory reserves by the aggregate reserves reported on a single annual statement. Under that reading, multiple annual statements cannot be examined to determine the highest reserves for specific contracts. Despite this ambiguity, the ruling provides useful and timely guidance.

Tax Factors Influence the Viability of NAIC Securitization Initiatives

by Emanuel Burstein

Securitizations and Expanded Insurance Capacity

Congress, state insurance regulators and insurance companies have been examining ways to expand insurance capacity by promoting insurance securitization arrangements. In Congressional hearings on applying certain securitization methods to increase insurance capacity for catastrophe risk coverage, Michael Moriarty,[1] representing the National Association of Insurance Commissioners (NAIC), stated,

> *The NAIC's position is that U.S. regulators should encourage the development of alternative sources of capacity such as insurance securitizations, provided adequate standards governing these transactions are applied. Further deliberations of the [insurance securitization] working group at the NAIC led to a determination that it will be preferable if insurance securitizations could be done here in the United States instead of off-shore.*[2]

He added that "to further that position, the NAIC has adopted separate model acts to facilitate on-shore securitization using two different methods—protected cells and special purpose reinsurance vehicles."[3] Protected cells and special purpose reinsurance vehicles facilitate the transfer of insurance risks to capital markets and enable investors to fund a sizable portion of transferred coverage.

Tax factors, including tax uncertainty, significantly influence the viability of these risk-transfer vehicles. Moriarty stated, "it is our understanding that an important impediment to the utility of both of these options here in the United States is tax uncertainty. Both of these methods depend on certain tax treatment which may require amendments to the tax code." Although Congress has not amended related provisions of the Internal Revenue Code, the Internal Revenue Service (Service) is providing greater tax certainty, at least for protected cell securitizations, by addressing related tax treatment in pronouncements, principally in Rev. Rul. 2008-8[4] and Notice 2008-19,[5] and seeking input from insurance tax

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[1] Mr. Moriarty was the director of the Capital Markets Bureau of the New York Department of Insurance.

[2] *Catastrophe Bonds: Spreading Risk: Hearing Before the Subcomm. On Oversight and Investigations of the House Comm. On Financial Services*, 107th Cong. (Oct. 8, 2002) at 7.[Hereinafter *Hearing on Catastrophe Bonds*]

[3] *Id.* Copies of the NAIC's Protected Cell Company Model Act (1999) and Special Purpose Reinsurance Vehicle Model Act (2001) are respectively included on pages 89-97 and 138-158 of the *Hearing on Catastrophe Bonds.*

[4] 2008-5 I.R.B. at 340.

[5] 2008-5 I.R.B. at 366.

professionals. This article summarizes these securitization techniques and related tax issues.

Protected Cell Companies

A protected cell company[6] is a legal entity under applicable state law that is "a domestic insurer that has one or more protected cells."[7] A protected cell is "an identified pool of assets and liabilities of a protected cell company segregated and insulated . . . from the remainder of the protected cell company's assets and liabilities."[8] The Protected Cell Company Model Act provides that the "creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company."[9]

The structure and mechanics of a protected cell company (PCC) securitization arrangement are illustrated in Rev. Rul. 2008-8,[10] in which a sponsor forms a PCC and holds its common stock. Each of the PCC's multiple cells is funded from premiums received for the cell's coverage and contributions from participant(s) (investor(s) in the cell), who hold preferred stock in the cell. The non-cellular assets include minimal capital and surplus required under the applicable state law.

Each cell must pay claims under contracts to which it is a party. Each cell also accounts for its income and expenses and is insulated from claims of creditors of other cells or the PCC's general account. In addition, each cell can make distributions to participants with respect to its class of stock without regard to whether any distributions are made with respect to any other class of stock. If a participant terminates its participation in the PCC the participant is "entitled to a return of the assets of the cell in which it participated, subject to any outstanding obligations of that cell."[11]

An insurance securitization using a protected cell company addresses important obstacles to the realization of securitizations by domestic insurers, which was the "central purpose" of the NAIC's Insurance Securitization Working Group.[12] One important obstacle to insurance securitizations by domestic insurers is the relatively high capital requirements imposed on these insurers. Arnold Dutcher, chair of the Insurance Securitization Working Group, stated, "the protected cell concept allows an insurance company to isolate assets and a specific risk exposure in a protected cell with only a marginal risk-based capital requirement."[13]

In addition, each cell can make distributions to participants with respect to its class of stock without regard to whether any distributions are made with respect to any other class of stock.

Tax uncertainly is another important obstacle to domestic insurance securitization transactions.[14] The Service and Treasury Department addressed standards that determine whether and when a protected cell provides insurance in Rev. Rul. 2008-8[15] and proposed standards that determine whether and when a protected cell, separate from the protected cell company that established the cell, would qualify as an insurance company in Notice 2008-19.[16]

In brief, in Rev. Rul. 2008-8 the Service and Treasury apply tax principles that determine whether captive insurance arrangements qualify as insurance to determine whether coverage by the cell qualifies as insurance.[17] Notice 2008-19 addresses when a protected cell is treated as an insurance company, which is addressed below, and requests comments on this and related issues, such as

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6 These entities also may be referred to as segregated account companies or segregated portfolio companies. *See* Notice 2008-19, section 2.04, 2008-5 I.R.B. at 367.

7 *See* section 3 of the NAIC's Protected Cell Company Model Act.

8 *Id.*

9 *Id.* section 4.C of the NAIC's Protected Cell Company Model Act.

10 2008-5 I.R.B. 340 (Feb. 4, 2008).

11 *Id.*

12 NAIC Proceedings 1999 3rd quarter vol. 1 at 330 (May 2002).

13 *Id.*

14 *See* notes 4 and 5 and accompanying text.

15 2008-5 I.R.B. 340.

16 2008-5 I.R.B. 366.

17 2008-5 I.R.B. at 341-342. The Ruling and Notice are addressed in Mark H. Kovey, "Protected Cells As Insurance Companies," *Taxing Times* (May 2008) at 37. The tax treatment of captive insurance companies is addressed in detail on pages 16-43 of Emanuel Burstein, *Federal Income Taxation of Insurance Companies* (2nd edition) (2007).

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reporting rules and the treatment of protected cells under consolidated return rules.[18] Rev. Rul. 2008-8 and Notice 2008-19 clarify much of the uncertain tax treatment and arguably indicate that the Service and Treasury are sensitive to the policy goals of Congress and insurance regulators.

A working group of the tax section of the New York State Bar Association argues in a letter to Treasury officials that treating a given cell as an insurance company is the correct tax result.[21]

Is a Protected Cell an Insurance Company for Tax Purposes?

Notwithstanding the characterization of a protected cell in the Model Act as a component of the protected cell company, the Service treats the protected cell as an insurance company in Notice 2008-19[19] if it satisfies the following two requirements,

> (1) "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 Protected Cell Company such that no creditor of any other cell or of the Protected 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 Protected Cell Company has a direct creditor claim against such cell); and"
>
> (2) "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 [sections] 816(a) or 831(c)."[20]

The Service does not elaborate on the basis for this conclusion but a Treasury official indicated at a May 2008 insurance tax conference that treating the protected cell as an insurance company eases the tax administration of these transactions.

A working group of the tax section of the New York State Bar Association argues in a letter to Treasury officials that treating a given cell as an insurance company is the correct tax result.[21] Separate cells should be treated as separate entities under the federal income tax law if the applicable local law requires the "legal separation of the assets and liabilities of each cell from the other cells."[22] The group members recommend that the Treasury issue a safe harbor that provides that a protected cell would be treated as a separate entity under the federal income tax if the protected cell (1) is created under the statute of a state or foreign sovereign jurisdiction and (2) the statute "provides for unambiguous separateness of assets and liabilities of the protected cell company and permits beneficial ownership to be held on a cell by cell basis."[23]

They also argue that the tax principles that the Service applied to characterize separate series when certain conditions were satisfied should apply to treat each cell as a separate entity for federal income tax purposes. A given series had to consist of separate pools of assets and streams of income, the owners could look only to such assets in redemption, liquidation or termination, and creditors' rights were limited to the assets of the series for recovery of expenses, charges or liabilities.[24]

The Service recently concluded in LTR 200803004,[25] for example, that each LLC portfolio of a "series limited

[18] *Id.* at 366-368.
[19] 2008-5 I.R.B. 366. It would require a given cell to acquire a tax identification number. *Id.* at section 3.02(b), 2008-5 I.R.B. at 367.
[20] *Id.* at section 3.01.
[21] Letter from New York State Bar Association: Tax Section, *Re: Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena*, to Douglas H, Shulman, Commissioner of Internal Revenue and Eric Solomon Assistant Secretary (Tax Policy) Department of the Treasury (May 2, 2008), available at *http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=15932.*
[22] *Id.* at 7.
[23] *Id.* at 8-9.
[24] *Id.* at 7.
[25] Oct. 15, 2007.

liability company" that held multiple asset portfolios was treated as a separate entity under the federal income tax. Characteristics of each LLC portfolio that reflected the separate identify of the portfolio included:

- Each portfolio will consist of a separate pool of assets, liabilities and stream of earnings.
- The shareholders of each portfolio may share in the income only of that portfolio.
- The ownership interest of a shareholder in the LLC is limited to the assets of that LLC upon redemption, liquidation or termination of the LLC.
- Payment of the LLC's expenses, charges and liabilities is limited to the LLC portfolio's assets.
- Creditors of an LLC portfolio can access only assets of the LLC portfolio to recover expenses, charges and liabilities.

The letter ruling involved the reorganization of a trust that held separate asset portfolios, each of which was treated as a separate Regulated Investment Company and taxable as a corporation. The Service recognized that each portfolio held by the new LLC was a separate entity because it concluded that each portfolio was classified for tax purposes as either a disregarded entity (which is treated as taxable as part of its owner), a partnership or a corporation depending on the number of the portfolio's owners and whether certain elections were taken.

Special Purpose Reinsurance Vehicles

The other Model Act involves Special Purpose Reinsurance Vehicles (SPRVs). In an SPRV arrangement an insurance (or reinsurance) company transfers certain of its risks, and pays premiums, to an SPRV. The SPRV also is funded by investors. The SPRV transfers the proceeds to a trust that invests in "Treasury securities and other highly rated assets."[26] The investors' security offering "defines a catastrophe that would trigger a loss of investor principal and, if triggered, a formula to specify the compensation level from the investor to the SPRV."[27]

The tax treatment of special purpose reinsurance vehicle arrangements, like that of protected cell securitization arrangements, needs clarification. In the 2002 Hearing on Catastrophe Bonds, a request was made for "pass-through" tax treatment of the SPRV.[28] Officials at the Reinsurance Association of America (RAA), however, were concerned that providing this tax treatment to SPRVs would place reinsurers that assume similar risks at a tax-based competitive disadvantage because the reinsurers are taxable entities.[29]

Conclusion

The NAIC, government agencies and insurance companies seek to increase insurance capacity by promoting insurance securitizations. Tax considerations, including uncertain tax treatment, influence the viability of securitization transactions that transfer risk from insurance companies to investors. The Service is resolving some uncertainties, principally in Rev. Rul. 2008-8 and Notice 2008-19, but tax legislation may be needed to promote certain tax policy goals, such as pass-through treatment for special purpose reinsurance vehicles. Tax and other rules also may have to attempt to minimize adverse consequences including potential competitive disadvantages imposed on other entities that accept similar risks from insurance companies and the possible use of any new rules in "abusive" transactions. ◂

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[26] U.S. General Accounting Office, *CATASTROPHE INSURANCE RISKS: The Role of Risk-Linked Securities and Factors Affecting Their Use,* GAO-02-941 (Washington, D.C.: Sept. 2002) at 20. [Hereinafter cited as GAO report]

[27] *Id.*

[28] *Hearing on Catastrophe Bonds at 7*. Cf. section 860A(a), which provides pass-through tax treatment for qualified mortgage loan securitizations by real estate mortgage investment conduits (REMICs). *But compare* FASIT rules, prior-law section 860H-860L, which were enacted by section 1621 of Pub. L. 104-188, The Small Business Job Protection Act of 1996, 110 Stat. 1858-1868 (August 20, 1996), to promote other qualified securitizations but repealed by section 835(a) of Pub. L. 108-173, The American Jobs Creation Act of 2004, 118 Stat. 1593 (Oct. 22, 2004), because the FASIT rules did not serve the purpose intended by Congress and were "prone to abuse." *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05) May 2005 at 396.

[29] *GAO report* at 28. The RAA officials also stated that the SPRV would "act as a reinsurer and yet [would] not be subject to insurance regulation." *Id.*

Let Your Voice Be Heard!

THE SOA 2008 ELECTION POLLS ARE NOW OPEN AND WILL CLOSE ON SEPTEMBER 10 AT 11:45 A.M. CENTRAL STANDARD TIME. ONLINE VOTING FOR THE ELECTION IS OPEN 24 HOURS A DAY.

Visit the SOA Web site at *http://www.soa.org/elections* to learn more about the candidates. You'll find:

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- Entire ballots including the Board, Bylaws amendment and proxy information and Section Council candidates.

This election has a SOA Bylaws amendment proxy to allow Associates—who have been members of the Society for five years or more—to vote in elections for President-Elect, Vice Presidents and elected Board of Directors. Remember: all information—including the suggested Bylaws amendment—can be found at http://www.soa.org/elections.

Let your voice be heard! Please vote!

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Questions regarding the election or bylaws amendment can be sent to *elections@soa.org*.

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