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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*.