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Tax Aspects of VA CARVM (*aka* Actuarial Guideline XLIII)

by Edward L. Robbins, Michael J. LeBoeuf and Victor E. Akin

After much work, deliberation and debate, the National Association of Insurance Commissioners (NAIC) has adopted a new principle-based reserve standard for variable annuity contracts with guarantees (VACARVM). Now that this new standard has been adopted, variable annuity writers will need to begin to prepare for the Dec. 31, 2009 implementation date. While there are many aspects to this preparation, one part will be to understand how the reserve calculations will differ under tax and statutory accounting. This article will address what those differences might be in light of recent concerns expressed by the Treasury Department (Treasury) and hopefully will provide the reader with some insights regarding tax planning under the new required methodology.

Background

While the introduction of life insurance principle-based statutory reserve requirements still appears to be at least several years in the future, statutory requirements for annuity "quasi principle-based reserves" have arrived. A guideline known as Actuarial Guideline XLIII (AG43) specifies statutory reserve requirements for variable annuities and related products. It has had a long history, and it is good to see that it has reached the end of the road, thanks to the hard work of the Variable Annuity Reserve Working Group (VARWG) of the American Academy of Actuaries (Academy) and the NAIC Life and Health Actuarial Task Force (LHATF). The effective date of AG43 is Dec. 31, 2009[1] and it is intended to replace Actuarial Guidelines 34 and 39. Given a short implementation period and its impact on both statutory and taxable income, the effect of this new guideline is substantial. For example, it is a retroactive guideline, requiring compliance for all policies issued beginning in 1981—thus, it encompasses virtually all inforce variable annuity contracts subject to CARVM.

The types of contracts that fall within the scope of AG43 include the following:

- Variable deferred annuity contracts subject to CARVM.
- Variable immediate annuity contracts.
- Group annuity contracts not subject to CARVM, but which contain guarantees such as Guaranteed Minimum Death Benefits (GMDBs) and/or Guaranteed Living Benefits (VAGLBs).
- Variable life contracts that contain guaranteed living benefits.

The Components of the Statutory Reserve Requirements under VACARVM

The reserve approach under AG43 is a "quasi principle-based" approach, combining both deterministic and stochastic elements. The two key components that comprise the reserve are the Standard Scenario Amount (SSA), plus the excess, if any, of the CTE[2] Amount over the SSA (this excess amount will be referred to from this point forward as the "Stochastic Excess"). The SSA is a deterministic reserve that serves as a floor for the AG43 reserve. It is determined by a seriatim (contract-by-contract) valuation approach, which, for interest and mortality assumptions, uses generally prescribed assumptions locked in from the issue date. Certain other assumptions, such as lapse and VAGLB election rates, which are a function of moneyness,[3] reflect current economic conditions as of the valuation date. The CTE Amount is a stochastically generated amount,

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FROM THE EDITOR

A Great Start to 2009

BRIAN G. KING

Hello readers and welcome to what I hope will be another great year of *TAXING TIMES*. On a personal note, this year marks the start of my second term as editor of this newsletter. I'm excited with many of the things we have planned for this year.

We kick off 2009 with not only this February issue, but also our accompanying supplement issue on the revenue procedures concerning product tax corrections released in early summer 2008. These revenue procedures have great significance for companies who are in a situation requiring remediation and I am confident that the articles in the supplement will prove very helpful and informative in explaining how the procedures work. In addition to the supplement, this February issue brings two articles and the ACLI update column—all deal with the recently adopted NAIC VACARVM guideline. This is another hot topic in the industry and we hope the coverage in this issue sheds some light on the tax implications of this new guideline.

Bringing to light new industry tax topics that educate our membership is one of the key goals of the Taxation Section. We want to provide our members with a forum for education, discussion and debate on those tax topics which impact their work. Given this goal, I am also excited about some new plans that the Taxation Section has in store for our members. As our chair, Kory Olsen, mentions in his column, the Taxation Section plans to introduce Web-based learning into our offerings for 2009.

This topic was discussed at the face-to-face meeting that the Taxation Section Council had at the SOA Annual Meeting this past fall. The consensus of the council was that the Taxation Section should develop experience and capabilities in this area. As Kory mentions, the Web learning can include basic tax topics and specific industry tax issues and it can count toward Continuing Professional Development (CPD) credits. Suggestions for follow-ups to this Web-based learning have included setting up a 24-hour chat room for follow-up discussion and recording webinars for rebroadcast.

While many possible topics were discussed for these webinars, the council felt that the best place to begin was with a webinar on the revenue procedures dealing with product corrections. This webinar is slated for March 4, 2009 (12:00–1:30 p.m., Eastern Time) and will hopefully enhance and compliment the information presented in our *TAXING TIMES* supplement on this topic.

Please try and participate in this, our first webinar, and offer us your feedback. This feedback will help the Section in planning future educational opportunities such as this one.

Enjoy the issue!

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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

FROM THE CHAIR

KORY J. OLSEN

With the publication of this newsletter, we have recently started a new calendar year—2009 comes with hope and promise. It is a time for setting goals for the upcoming year that correspond with Section member needs and broaden the scope and reach of the Taxation Section.

As I write this article, the SOA Sections recently started their new year. New calendar years bring an opportunity to set new goals and drive new initiatives. It also provides an opportunity to review the successes and achievements of the year just past as well as the areas that need more attention and growth. All of this was recently done by the Taxation Section Council at the SOA Annual Meeting.

During 2008, the council has sponsored many education opportunities. This includes sessions at the Annual and Spring meetings as well as involvement in many seminars. As in the past, our shinning gem was the Product Tax Seminar. This seminar taught the basics of product tax and went into the details of current industry issues. The value of this seminar is increased with the willing participation of individuals from the Treasury Department (Treasury) and the Internal Revenue Service (IRS).

Of course, the achievements of last year would be remiss without mentioning the continued success of our newsletter, *TAXING TIMES*. The newsletter has become the publication to read for insurance tax professionals. I would especially like to thank those directly involved with the publication of our newsletter for all their hard work including; editor (Brian King), assistant editor (Christine Del Vaglio) and our great editorial board (Peter Winslow, Bruce Schobel and Frederic Gelfond). I would also like to thank all of you who have submitted articles over the years. This great publication wouldn't be possible without you.

The year just past wouldn't have been the same without our outgoing council members. I would also like to thank them for all their hard work over the years. Leslie Chapman, George Hebel, Brian King and Art Panighetti have been an asset to the council and we look forward to their continued support and working with them as Friends of the Council.

Looking forward to the next year, I would like to welcome our incoming council members: Steve Chamberlin, Jo Finley, Vincent Tsang and Brian Prast. They bring with them new ideas and a new perspective. I look forward to working with each of them to better serve our members.

In the new year, the council looks to improve and enhance what the Section has been doing, as well as trying some new ideas. For example, we will be bringing more educational opportunities to you via Web-based learning. This will include both basic tax education and current industry topics. This will also facilitate our members meeting their Continuing Professional Development (CPD) credits.

In the meantime, there are other tax education opportunities available. An FSA could sign up for one of the FSA modules. The Taxation Section was involved in including significant U.S. and Canadian tax content for both the Regulation Module and the Financial Reporting/Operational Risk (FROR) Module. Once signed up, the access to the module would last for a year, for review at your own pace. The Regulation Module includes both policyholder and company tax, whereas the FROR Module only includes company tax. The tax material is in addition to other great topics covered in each module. This would give you the opportunity for a refresher or to learn something new. Successful completion of an FSA module (without the end-of-module exercise) would also earn 7.5 units of job-related structured CPD credits. Users of the module have access to a discussion forum (therefore, it would count as structured learning).

I am excited about the plans for the coming year. If you would like to volunteer and be part of this excitement, please contact me at *kory.olsen@pacificlife.com*.

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using randomly varying interest rates and equity paths, and using prudent estimates for other assumptions (*e.g.*, mortality, persistency, etc.).

We will be discussing the SSA in the remainder of this article, leaving aside the CTE Amount in this article, for two reasons:

1. The pragmatic reason, that the entity-specific assumptions and modeling instructions underlying the CTE Amount would make it difficult to write a comprehensive but short document on this that would also contain insights on tax implications.

2. Recent industry commentary has reported that VACARM surveys of major variable annuity writers show that the SSA dominated over the CTE(70) amount in almost all cases. When this occurs there is no Stochastic Excess element to the reserve. Thus, the deterministic component generally sets the reserves under AG43.

Description of the Standard Scenario Amount
The SSA is based on a seriatim calculation of the Standard Scenario Reserve (SSR) for each contract. If a contract has guaranteed benefits (as defined in AG43, Section III), the SSR equals the Basic Adjusted Reserve (BAR) plus a "greatest present value" (GPV) measure.

- The BAR is essentially the Actuarial Guideline 33 CARVM methodology, with two exceptions:

- Free partial withdrawal provisions are disregarded.
- The NSV "floor" is ignored at this point in the calculation.

- The GPV equals the greatest present value measured at the end of each projection year of the negative of the Accumulated Net Revenue (ANR). The ANR at the end of any future projection year equals:

- The ANR at the end of the prior projection year accumulated one year at the prescribed interest rate, plus the "margins" defined in AG43, less benefits paid in excess of account values applied.

Finally, the GPV cannot be negative.

Additional adjustments to the SSR will be required for hedges and "aggregate reinsurance ceded." Following these adjustments the SSR is floored at the net surrender value (NSV).

If there are no guaranteed benefits in excess of account value, then the traditional integrated reserve formula approach is to be used, instead of the above. However, since virtually all individual variable annuity contracts inforce and currently issued contain guaranteed benefits (a return of premium feature on the GMDB at the very least), the SSR is applicable to virtually all of these products.

Thus for tax purposes the details of the SSR deserve serious consideration and appear to have a good chance to survive virtually intact.

Tax Implications
The Treasury promulgated Notice 2008-18 early this year. It was a product of Treasury discussions with representatives of the Academy and the American Council of Life Insurers (ACLI), as well as the Treasury's reading of certain articles published in *TAXING TIMES*. While the Notice registered significant concerns about stochastically generated reserves, it pointed out the following: "the Treasury Department and IRS believe that the standard scenario under proposed AG VACARVM . . . would more closely resemble the methodology in effect when Congress enacted section 807 in 1984 than would the CTE amount or stochastic reserve." Thus for tax purposes the details of the SSR deserve serious consideration and appear to have a good chance to survive virtually intact. Assuming this is true, the discussion below addresses a number of issues and observations that may result from implementation of SSR.

Interest Rates. It is expected that the tax basis SSR will generally be close in value to the statutory SSR. The primary differences will be in the valuation rate used in computing tax and statutory SSR.

- The valuation rate for the statutory SSR is the prescribed Discount Rate (DR) while the tax valuation rate for the SSR will likely use the greater

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of the DR or the applicable Federal interest rate (AFIR).[4]

- In case there are any forward interest guarantees on combination contracts (variable annuities with general account options), Code Section 811(d) will limit the forward deemed interest guarantee to the valuation rate for purposes of computing the tax SSR.

Prospective vs. Retrospective Application. AG43 applies retroactively to variable annuity contracts issued in 1981 and later. Any modifications to the methodology used to compute tax reserves under Internal Revenue Code Section 807(d) resulting from AG43 will apply on a prospective basis to newly issued contracts. This will cause Federally prescribed reserves (FPR) or tax reserves for contracts issued between 1981 and 2008 to be subject to the traditional CARVM rules [the Standard Valuation Law (SVL), as interpreted through Actuarial Guidelines 33, 34, and 39],[5] while statutory reserves for virtually all inforce contracts will fall within VACARVM's scope. This will cause significant nonparallel effects between the two systems.

Stochastic Excess and the Statutory Cap. Statutory capping will most likely come into effect for significant portions of inforce business, largely because of the nonparallel effects described above.[6] While there are Treasury concerns about the deductibility of the Stochastic Excess, AG43 contains a reasonable methodology for allocation of such excess to individual contracts, based on each contract's relative contribution to the Stochastic Excess. As such, the Stochastic Excess will likely add to the statutory cap, since it constitutes part of the statutory reserve.

Contract Year vs. Calendar Year. There is possibly a subtle but important difference in the way in which SVL and AG43 define the term "year." The SVL specifies that the greatest of present values should be determined as of the "end of a contract year," while AG43 references calendar year in the SSR GPV calculation. Technical Advice Memorandum (TAM) 9452001 reiterates the "end of contract year" point, as follows:

Thus, CARVM specifically requires a determination of the present value of each of the future guaranteed benefits, including nonforfeiture benefits, provided for by an annuity contract at the end of each respective contract year. For many annuity policy designs, for example, when there is a grading off of surrender charges at each successive contract anniversary date, the use of end of year contract values to determine the present value of future guaranteed nonforfeiture benefits under CARVM results in a lesser reserve provision than if beginning of the year contract values were used.

For example, an actuarial textbook observes:

> *. . . CARVM requires calculating present values based on benefits as of the end of each policy year. The language specifically states end of year values should be used, and examples found in the NAIC Proceedings use end of year methodology, even though beginning of year methodology would have produced larger reserves for the policies shown in these examples. Thus it is clear that the drafters of CARVM intended for end of year values to be used, even though they realized (as evidenced by the example in the Proceedings) that typical SPDA designs would produce larger reserves if beginning of the year values had been used.*
>
> *Tullis and Polkinghorn, Valuation of Life Insurance Liabilities, 73 (2d ed. 1992).*

The fact that this TAM explicitly referred to the definition of CARVM in the SVL—rather than to any actuarial guideline—is arguably consistent with the principle of law that a statute overrides any regulatory interpretation in case the two are in conflict. Hopefully, this timing difference in the guidance will not cause a difference between statutory and tax calculations. Furthermore,

the BAR requirement will continue to be as of contract year- end, while only the GPV contains a calendar year-end calculation requirement.

Static vs. Dynamic Assumptions. The discount rate and mortality assumption appear to satisfy the issue year lock-in concept under Code section 807(d). Certain other assumptions are functions of the current environment as of the valuation date, and such treatment would appear to be permissible under the Code, as long as those assumptions are the same for statutory and tax purposes. Those other assumptions would include lapse assumptions and VAGLB election assumptions, which are functions of the current moneyness of the contract as of the valuation date.

Assumption or Methodology Change? Several of the assumptions (*e.g.*, lapse rates and election rates) are subject to change during the lifetime of a contract, but for which the assumption methodology is locked in from the issue date. This could possibly be construed to warrant section 807(f) treatment, under which the 10-year spread rules would be applicable. However, it appears that the better argument is that the assumptions are under a methodology that does not change from the issue date of the contract, and that therefore does not warrant spread treatment.

Margins. Another assumption that is subject to change during the lifetime of a contract is the margin used in the GPV calculation. This margin is a function of the Surrender Charge Amortization Period (SCAP), which in turn is a function of the "BAR duration."[7] Since the BAR is based on the current account value as of the valuation date, the SCAP, and therefore the future margin pattern, could possibly change over time for reasons beyond the simple passage of time between valuation dates. Here again, consistency between statutory and tax approaches would appear to be required, although the difference between tax and statutory discount rates might cause a difference between statutory and tax SCAPs.

Concluding Comments

We hope this article has provided you insights into the tax issues that must be reviewed and addressed as your company moves forward in implementing AG43. While the tax issues under AG43 have not been fully fleshed out or commented upon by the Treasury, we anticipate that more guidance will be forthcoming over the next year.

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End Notes

1. With a grade-in period of up to 3 years, subject to the permission of the Domiciliary Commissioner.
2. "Conditional Tail Expectation." This term is expressed as "CTE(X)", or the average of the highest (100-X) percent "scenario greatest present values" in the stochastic process. A scenario greatest present value is the greatest present value of "accumulated deficiencies" in a given scenario projection, plus the starting asset value. "CTE(70)" is the average of the highest 30 percent scenario present values.
3. Moneyness is a term used to tell whether the current value of a guaranteed option is above the contract's account value. "In the Money" means that such current value is currently in effect (*i.e.*, above the account value). "Out of the money" means that such current value is less than the account value.
4. There is a possibility that the DR will not be considered the "Prevailing Statutory Assumed Interest Rate," inasmuch as state action has not taken place to accept the DR in 26 or more states. It is unusual (and arguably improper) for an actuarial guideline to stipulate a mortality table or an interest rate, a matter more properly attended to by administrative action by the individual states.
5. It should be noted that Guidelines 34 and 39 both contain stochastic testing requirements, whose deductibility has been challenged by the IRS on audit. Further, Guidelines 33 and 39 each have two versions: an original one and a revised one. Under a reasonable interpretation of section 807(d), this causes a separation of "tax CARVM" into additional generational granularity. As section 807(d)(3)(B) indicates: "The term 'CARVM' means the Commissioners Annuities Reserve Valuation Method prescribed by the [NAIC] which is in effect on the date of the issuance of the contract."
6. 'Statutory capping' refers to the language in section 807(d)(1), which stipulates in pertinent part, "In no event shall the reserve determined under the preceding sentence [the greater of NSV or FPR] for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves…"
7. The duration of the greatest present value used in the BAR calculation.

Assessing the Transfer of Risk: An Actuarial Perspective

by Christian DesRochers

Risk transfer can be a difficult subject to define and describe. At the same time, demonstrating that risk has been transferred in an insurance or reinsurance arrangement is critical to both the applicable tax and accounting treatment. For actuaries, the challenge is to develop an analytical framework under which the presence of insurance risk can be identified and assessed.

Risk arises when there is uncertainty about the occurrence of a loss. Uncertainty includes both *process risk*, which arises from the random nature of a probability distribution, and *parameter risk*, which arises from the selection of the wrong distribution, or from changes in the expected distribution over time. That is, the uncertainty associated with a probabilistic model of the distribution of possible outcomes has two distinct sources: the inherent variability of the phenomenon, and incomplete knowledge and/or inaccurate representation of the probabilities of alternative sets of outcomes. Put differently, process risk is the risk of getting the outcomes distribution right, but being unlucky, while parameter risk is the risk of getting the outcomes distribution wrong.

Accounting Standards

Accounting standards are one source of definitional guidance related to risk transfer. Financial Accounting Standards Board Statement (FAS) 113 ("Accounting and Reporting for Reinsurance of Short-Duration and Long Duration Contracts") was implemented in 1993 in an effort to prevent, among other things, abuses in GAAP accounting for contracts that have the formal appearance of reinsurance but do not transfer significant insurance risk and, thus, should not be eligible for reinsurance accounting. FAS 113 amplified an earlier requirement of FAS 60 ("Accounting and Reporting by Insurance Enterprises") that reinsurance accounting only applies to contracts that transfer insurance risk.

In order for an arrangement to qualify for reinsurance accounting treatment (as opposed to deposit accounting treatment) in accordance with FAS 113, it must transfer insurance risk from an insurer to a reinsurer. To meet the risk transfer requirement, a reinsurance treaty must satisfy one of two conditions:

1. It must be evident that "the reinsurer has assumed substantially all of the insurance risk relating to the reinsured portion of the underlying insurance contracts" (paragraph 1.1), or
2. The reinsurer must "assume *significant* insurance risk under the reinsured portion of the underlying insurance contracts" (paragraph 9a) and it must be *"reasonably possible* that the reinsurer may realize a *significant* loss from the transaction" (paragraph 9b). (Emphasis added.)

Similarly, under statutory accounting, a ceding company is permitted to effectively remove the reserve for reinsured liabilities from its balance sheet in recognition of the fact that the underlying risks have been transferred to the reinsurer. The principles of FAS 113 are incorporated into statutory annual statement accounting through the National Association of Insurance Commissioners' (NAIC) Statement of Statutory Accounting Principles (SSAP) Nos. 61 (Life, Deposit-Type and Accident and Health Reinsurance) and 62 (Property and Casualty Reinsurance), which provide almost exactly the same guidance as FAS 113. However, neither FAS 113 nor SSAP 61 or 62 provide guidance on the precise meaning of the terms "reasonably possible" and "significant loss."

Outside the United States, the accounting definition of insurance contracts—including the issue of risk transfer—is governed by the International Accounting Standards Board (IASB), which promulgates international accounting standards. International Financial Reporting Standard (IFRS) No. 4 ("Insurance Contracts"), dealing with accounting for insurance contracts was issued in March 2004, effective for accounting periods beginning on July 1, 2005. Under IFRS 4,

the definition of insurance risk refers to risk that the insurer accepts from the policyholder and the definition of an insurance contract refers to an adverse effect on the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Appendix B of IFRS 4 also discusses assessment of whether insurance risk is significant. That is, *"insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (*i.e.*, have no discernible effect on the economics of the transaction)."* (Emphasis added.) If an insurance contract is unbundled into a deposit component and an insurance component, the significance of insurance risk transfer is assessed by reference to the insurance component.

Federal Income Tax Definition

Beginning in the early 1940s an actuarial or economic definition of insurance was applied for federal tax purposes, focusing on the shifting and distribution of risk. The landmark case of *Helvering v. Le Gierse,*[1] (and similar cases) presented the courts with a choice of continuing the contract-based definition for commercial insurance policies or applying an actuarial or economic analysis. Ultimately, in the *Le Gierse* case, the Supreme Court chose to apply the economic approach, ruling the simultaneous purchase of a single premium life insurance policy and a nonrefund life annuity contract had eliminated any meaningful risk undertaking on the part of the insurer and thus the policy under the arrangement was not eligible for tax treatment as life insurance.[2] *Le Gierse* established the principle that although a contract (or a combination of contracts) is in the form of a standard commercial life insurance contract, it is not treated as an insurance contract for purposes of federal tax law unless it provides for risk-shifting and risk-distributing (or pooling). Essentially, the court took these as descriptive of the essential characteristics of insurance. One court explained the concept as follows:

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of the potential loss by spreading its cost throughout the group.[3]

However, in requiring the presence of risk-shifting and risk-distribution, the Supreme Court in *LeGierse* left open the question of how much is enough for an insurance contract to qualify under the Code.[4]

From an analytical perspective, in Revenue Ruling 89-96 (the "MGM Grand" ruling), the Internal Revenue Service (IRS) applied an economic analysis to hold that a retroactive insurance arrangement was not insurance for federal income tax purposes. As described in a 2007 Non-Docketed Service Advice Review (NSAR):

> The Service contends that in essence, Revenue Ruling 89-96 equates the tax savings received, when booked as an underwriting loss, to an additional premium which the taxpayer can invest to cover expected claims. Therefore, to evaluate the economics of the transaction, this tax savings along with the actual premium is compared to the net present value (NPV) of the anticipated losses. If the NPV of the anticipated losses do not materially exceed the premium plus the tax savings, the transaction does not transfer insurance risk for federal income tax purposes.[5]

The same NSAR also noted that "The annual statement and SSAP 62 are not controlling for federal income tax purposes. While an arrangement that fails the risk transfer requirements of SSAP 62 is almost certain to fail the risk transfer requirements for federal income tax purposes, satisfying SSAP 62 is no guarantee of success for federal income tax purposes."

Actuarial Analyses

The accounting requirements discussed above have resulted in an emerging literature in the actuarial field that attempts to analyze and implement the accounting standards with respect to risk transfer in the context of reinsurance agreements. In that regard, although FAS 113, SSAP 61 and SSAP 62 establish certain standards in terms of risk transfer that a reinsurance agreement must meet, they do not provide a definition or a test by means of which risk transfer can be assessed in such contexts. Instead, the accounting guidance speaks only in the largely undefined terms of a transfer of substantially all existing risk, or a transfer of "significant risk." The emerging actuarial literature attempts to identify specific tests or standards that can be used to measure and evaluate the level of risk transfer in reinsurance arrangements such that the rather vague standards in the accounting literature can be met.

In 2002, the Valuation, Finance, and Investments Committee (VFI Committee) of the Casualty Actuarial Society (CAS) authored a study entitled "Accounting Rule Guidance Statement of Financial Accounting

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Standards No. 113 – Considerations in Risk Transfer Testing" (2002 CAS Paper). With regard to risk transfer testing methodologies, the 2002 CAS Paper notes that the phrases "reasonable possibility" and "significant loss" are clearly the key considerations in the analysis of risk transfer under FAS 113. Thus, the paper observes that the explicit reference in FAS 113 to probability and significance gives rise to viewing risk in two parts—frequency and severity. In addition, the 2002 CAS Paper notes that, because these two concepts are intertwined in FAS 113, they should be considered in tandem, rather than considered independently; for example, the standard for "reasonable possibility" should be stricter in circumstances where "significant loss" is being construed more liberally, and *vice versa.*

In 2005 the CAS Research Working Party on Risk Transfer Testing authored a report entitled "Risk Transfer Testing of Reinsurance Contracts: Analysis and Recommendations" (2005 CAS Paper). The 2005 CAS Paper was prepared in response to a call from the American Academy of Actuaries' (the Academy) Committee on Property and Liability Financial Reporting (COPLFR), in which COPLFR requested ideas about how to define and test for risk transfer in short duration reinsurance contracts as required by FAS 113 and SSAP 62. In responding to that request, the 2005 CAS Paper notes that "[t]here is very little published actuarial literature on the subject,"[6] and refers to the 2002 CAS Paper as "the only significant paper" on the subject.

The financial consequence of a loss serves as the basis for quantifying risk.

A third paper is a 2005 report authored by the Academy's COPLFR, entitled "Risk Transfer in P&C Reinsurance: Report to the Casualty Actuarial Task Force of the National Association of Insurance Commissioners" (2005 Academy Paper). The 2005 Academy Paper contains a survey of current industry practices regarding risk transfer and alternative approaches to evaluating risk transfer.

In 2007, the Canadian Institute of Actuaries (CIA) Task Force on the Appropriate Treatment of Reinsurance issued a report that addressed risk transfer. In their report, the CIA Task Force identified four key principles of risk transfer:

1. There are several approaches that can be used to assess the existence of risk transfer.
2. Professional judgment will be required when assessing the existence of risk transfer.
3. The entire agreement consisting of the reinsurance contract and all written and verbal agreements and correspondence must be considered in assessing the existence of risk transfer.
4. The existence of risk transfer must be assessed at inception of the contract and every time a change to the contract that significantly alters the expected future cash flows of that contract is made.

Risk Metrics

From an analytical perspective, risk can be said to be transferred if there are plausible scenarios under which a loss to the insurer can occur. The financial consequence of a loss serves as the basis for quantifying risk. However, as noted above, there is no single actuarial method, test or rule that can be applied to definitively assess the existence of risk transfer. As a result, there are several approaches that can be applied in evaluating whether a particular insurance contract has transferred risk. However, these can generally be characterized in two broad categories: qualitative assessment and quantitative testing. A qualitative assessment may conclude that risk transfer is "reasonably self-evident" or that risk is transferred under a given accounting or tax standard. A low frequency, high severity risk (*e.g.*, a catastrophic risk) is an example of a reasonably self-evident risk. Quantitative testing involves the application of a risk metric to measure the existence of risk transfer. A risk metric is a single number or index value that quantifies the exposure to risk in a way that risks can be measured or compared. As such, risk metrics are useful in measuring both the existence and extent of risk transfer. However, every risk metric in itself contains an implicit definition of "risk." Further, quantitative testing generally addresses process risk, as it measures the effects of statistical variations assuming that the underlying loss distribution is known.[7]

VaR, CTE and TVaR

Value-at-risk (*VaR*) defines risk by a percentile of the tail of a loss distribution, such as the 95th percentile of annual loss. It is statistical, rather than economic, in nature. Conceptually, *VaR* represents the amount a firm could lose with a specified probability, given a distribution of possible losses. The concept has become very popular in the banking and investment banking communities, where it has become the standard risk

measure used to evaluate exposure to risk. Typically, *VaR* is used by banks and other financial institutions to measure risk over a short (less than one month) time frame. In solvency terms, the *VaR* is the capital required to ensure, with a high degree of certainty, that the enterprise doesn't become technically insolvent. However, the degree of certainty chosen is arbitrary.

Tail value-at-risk *(TVaR)*, also known as conditional tail expectation *(CTE)*, is the probability-weighted average severity of the worst outcomes. A *CTE* analysis at a given level is the basis for the stochastic element of principle-based reserves (including VACARVM as described in Actuarial Guideline 43). Like *VaR*, the *TVaR* or *CTE* measure uses a percentile (the average outcome in the worst 10 percent of cases would be called "*TVaR* (90)" or "*CTE* (90)"). Unlike *VaR,* however, *CTE* captures the entire tail of a loss distribution beyond the specified percentile rather than one point. One definition of *CTE* is that it is the average of all *VaR* values for probabilities above a specified level. The *CTE* measure captures both the probability and magnitude of large losses, as a *CTE* calculation includes the impact of all losses above the specified percentile of the loss distribution. In contrast, a *VaR* measure will only reflect losses occurring at the percentage chosen for the *VaR* measure. *CTE* is becoming the standard for insurance company risk measurement, particularly regarding risk-based capital requirements. From a solvency viewpoint, *CTE* can be used to measure the average capital that would be consumed by an unusual, adverse event, with the percentile chosen defining what is considered "unusual."

As described above, FAS 113 provides guidance on the question of risk transfer in the context of GAAP accounting for reinsurance. With less than precise guidance on this question from FAS 113 a "10-10" benchmark arose within the accounting and actuarial communities as an informal method for testing whether a reinsurance contract transferred sufficient risk of loss to be accounted for as reinsurance and not a deposit. The "10-10" test refers to a 10 percent chance of a 10 percent loss to the reinsurer, and is equivalent to a value-at-risk in the 90th percentile. It is usually interpreted to mean that, under at least 10 percent of modeled outcomes (*i.e.*, the 90th percentile of the distribution), there is a loss of at least 110 percent of the risk premium received by the reinsurer. Thus, the 10-10 test assumes that "significant" loss means a loss of at least 10 percent of premium and that "reasonably possible" means at least a 10 percent chance.

These percentages are not reflective of any particular guidance on what might be considered "significant" or "reasonably possible." Rather, they reflect a common interpretation of those terms within the accounting and actuarial fields as it pertains to reinsurance, although in practice other critical values are commonly used based on the judgment of the practitioner.

The 10-10 test was not originally intended to be applied to traditional reinsurance contracts, but rather was intended to be used in testing for risk transfer in highly structured reinsurance contracts that appeared to limit risk to the reinsurer.[8] Through its use in that context, however, it became the *de facto* standard for reinsurance risk transfer testing. Although it is simple and has a certain amount of intuitive appeal, as a standard, application of the 10-10 test can produce results that are analytically unsound. Notably, the 2002 CAS Paper criticized the 10-10 test as an inadequate risk transfer test for a number of reasons, including the fact that the test looks at risk at only one point on the distribution of possible outcomes (namely, the 90th percentile). The 2005 CAS Paper echoes the same criticisms of that test that were expressed in the 2002 CAS Paper, but notes that the prior paper was "fairly muted in its criticism of '10-10,' and it did not strongly advocate replacing it with an alternative."[9] In contrast, the 2005 CAS Paper advances a clear and convincing case for the abandonment of the 10-10 test, stating that "the time has come to be explicit about the shortcomings of the '10-10' test that has come into common use and to advocate its replacement with a better framework."[10]

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The Insolvency Put Option and EPD

The degree to which a policyholder is at risk for an insurer's insolvency is described in some literature as the "insolvency put option" or the "expected policyholder deficit" (EDP). When customers purchase insurance from a particular company, they implicitly give this option to the company.[11] The insolvency put option is the expected loss to policyholders due to the possibility that the firm will default. From a quantitative viewpoint, a positive expected value for the insolvency put option is a measure of the risk that has been transferred.

The option can be illustrated using a one-period, two-date model in which an insurer issues policies at time 0 and claims occur at time 1. If the insurer's assets exceed liabilities at time 1, the firm pays the losses. However, if assets are less than liabilities, the insurer defaults and the policyholders receive the assets. The payoff to policyholders at time 1 is thus equal to:

Claim Payment = L - Max [L-A,0]

where L = losses, A = assets, and Max[L-A,0] is the payoff on the insolvency put. If the insolvency put is not "in the money" the full claim is paid. In this context, the expected policyholder deficit is the average, or expected, deficit over all values where a deficit exists. In the table below, although both loss distributions have the same expected value, the EPD is $20 in the first case and $1,000 in the second, indicating that the policyholders in the second instance have granted the insurer a greater insolvency put option. This implies that the insurer in the first example would need surplus equal to 0.2 percent of premium to offset the insolvency put, while the second insurer would require surplus of 10 percent of premium.

Two Insurers with Same Balance Sheet but Different Unpaid Loss Distributions, Bustic Table 1

	Asset Amount	Loss Amount	Capital Amount	Probability	Weighted Loss	Claim Payment	Deficit
Insurer A							
Scenario 1	13,000	6,900		20%	1,380	6,900	0
Scenario 2	13,000	10,000		60%	6,000	10,000	0
Scenario 3	13,000	13,100		20%	2,620	13,000	-100
Expectation	13,000	10,000	3,000		10,000	9,980	20
EPD % Premium							0.20%
Insurer B							
Scenario 1	13,000	2,000		20%	400	2,000	0
Scenario 2	13,000	10,000		60%	6,000	10,000	0
Scenario 3	13,000	18,000		20%	3,600	13,000	-5,000
Expectation	13,000	10,000	3,000		10,000	9,000	1,000
EPD % Premium							10.00%

The solvency of an insurer is linked to the condition of its balance sheet and insolvency occurs when obligations to policyholders exceed assets.

Bustic defined the concept of *EPD* as a risk measure for solvency analysis.[12] The solvency of an insurer is linked to the condition of its balance sheet and insolvency occurs when obligations to policyholders exceed assets. The concept of the insolvency put option, which is also referred to as EPD, Expected Underwriter Deficit (EUD) or Expected Reinsurer Deficit (ERD), can also be applied as a measure of risk. As a threshold value, the presence or absence of an insolvency put option can serve as a quantitative measure of risk transfer.

As a measure of risk, *EPD* is more informative than *VaR* because it considers the expected amount of loss that will occur with a specified probability rather than just the amount of loss that will be exceeded with a specified probability. *EPD* is closely related to *CTE* or *TVaR*, as it is simply the *CTE* of all loss scenarios. Where *CTE* considers all scenarios, whether gain or loss, in the chosen percentile of the distribution, *EPD* is the average of scenarios in which there is a loss.

The 2002 CAS Paper notes that the *ERD* test "has some appeal in that it is well grounded in actuarial theory concerning the measurement of risk,"[13] and that it overcomes the weakness of the 10-10 test (and that of *TVaR* test) by looking across the entire spectrum of profit and loss, rather than at a singular point or range, to define risk transfer. However, the 2002 CAS Paper does not attempt to identify what critical value of *ERD* would need to be detected in order for there to be a showing of a significant or meaningful risk transfer. In that regard, the paper concludes that "[r]egardless of the model employed or the risk metric used, judgment is still required as to where to establish the threshold or critical values for what constitutes risk transfer and what does not." [14]

The 2005 CAS Paper concludes that the *ERD* test is a better alternative to the 10-10 test. In reaching this conclusion, the 2005 CAS Paper states that the *ERD* test overcomes the primary shortcomings of the 10-10 test, in that it (1) does not ignore the information in the portion of the distribution tail beyond the 90th percentile, and (2) replaces the separate frequency and severity requirements of the 10-10 test with a single, self-adjusting, and integrated measure that treats low-frequency/high-severity, high-frequency/low-severity, and moderate-frequency/moderate-severity contracts in the same way.

Like the 2002 CAS Paper, the 2005 CAS Paper does not attempt to identify what critical value of *ERD* would need to be detected in order for there to be a showing of a significant or meaningful risk transfer. As described above, the authors of the 2002 CAS Paper stated that "judgment is still required as to where to establish the threshold or critical values for what constitutes risk transfer and what does not." The 2005 CAS Paper attempts to identify tests that can be used to satisfy both of the general standards in the accounting literature described above, *i.e.*, that an arrangement either (1) transfers "substantially all" of the insurance risk, or (2) transfers a "significant" insurance risk that is "reasonably possible" to result in a "significant" loss to the carrier. However, the main focus of the 2005 CAS Paper is on testing for "significant" risk transfer, which corresponds to the latter standard in the accounting principles discussed above.

In the 2005 CAS Paper, the authors illustrate the application of the *ERD* test with a threshold value of 1 percent (determined by multiplying the separate 10 percent frequency and severity requirements of the 10-10 test together), because "it has the merit of a certain amount of continuity with the '10-10' test." Thus, the 2005 CAS Paper does not cite any particular guidance in interpreting "significant" loss or "reasonably possible," but rather adopts the common interpretation of those terms within the actuarial field as it pertains to reinsurance by following the 10 percent thresholds reflected in the 10-10 test. As described above, in practice other critical values are commonly used based on the judgment of the practitioner.

Based on the foregoing parameters of the *ERD* test, the 2005 CAS Paper reaches the following specific conclusions:

- The *ERD* methodology, with a 1 percent threshold for significant risk transfer, is numerically comparable to the 10-10 benchmark;
- The *ERD* test is qualitatively superior to that benchmark; and
- It would be a "significant improvement" if the 1 percent *ERD* test were adopted as a *de facto* standard in place of the 10-10 test.

One quality of the *ERD* test is that any contract that passes the 10-10 test will necessarily pass the *ERD* test. As described above, one criticism of the 10-10 test is that contracts might be "carefully engineered to allow for exactly a 10 percent probability of a 10 percent loss and little or no possibility of a loss greater than 10 percent." Because a contract that passes the 10-10 test also will pass the *ERD* test, this criticism could be made of the *ERD* test as well. In order to address this potential criticism, the 2005 CAS Paper suggests that it might be appropriate to consider a supplemental requirement that there be the potential for a loss of some minimum threshold, say, 15 percent or 20 percent of premiums.

Conclusions

As described at the outset, the issue is whether, using valid actuarial or statistical methods, an insurance arrangement can be shown to transfer a demonstrable, meaningful and significant level of insurance risk from the purchaser to the insurer. In that regard, any analysis must begin by first recognizing that there is no definition in actuarial science of the term "meaningful" or "significant" insurance risk. At the same time, actuarial tests can be used to provide quantitative measures of risk, although there are no threshold values at which sufficient risk can be said to be transferred to meet a particular tax or accounting standard. In fact, many of the tax methods themselves are qualitative. There is no one analytical standard that must be met for risk to be transferred. However, the presence or absence of an insolvency "put" option may be the best of the analytical tests. Even so, the definition of "how much" remains unsettled.[15] However, as discussed above, there is guidance from the financial and statutory accounting fields that discusses the accounting treatment of insurance arrangements that evidence a "significant" transfer of risk. Despite that, whether risk has been transferred in an insurance arrangement remains a matter of judgment. A qualitative assessment may conclude that risk transfer is "reasonably self-evident" or that risk is transferred under a given accounting or tax standard. A low

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frequency, high severity risk *(e.g.*, a catastrophic risk) is an example of a reasonably self-evident risk. Moreover, failure to meet a quantitative standard may not rule out an insurance arrangement from transferring risk, as it may still qualify under a "reasonably self-evident" standard. Thus, while risk metrics can provide a quantitative measure of risk transfer, the question of how much is enough will still remain unsettled and will continue to be a facts and circumstances analysis that will challenge both taxpayers and tax authorities in attempting to characterize a particular transaction as insurance.

End Notes

1. 312 U.S. 531 (1941).
2. *See Commissioner Of Internal Revenue v. Keller's Estate et al*. (3rd Cir., 1940), 113 F.2d 833 in which the Court Of Appeals for the Third Circuit observed, "a single premium on a whole life insurance of $1 (payable at the instant of death) combined with a single premium on a complete annuity (apportioned in the year of death) of the interest (i) on $1 will always equal $1. …. The mortality factors a_x and A_x cancel out no matter what age is used."
3. *Commissioner of Internal Revenue v. Treganowan* (2nd Cir, 1950), 183 F.2d 288 at 291; Cert Den., 340 U.S. 853.
4. For a detailed discussion of federal income tax issues and risk transfer, *see* F. Gelfond, *Fortuity*, *or Not Fortuity? …That Is the Question, TAXING TIMES* SUPPLEMENT, September 2008.
5. IRS NSAR 20072502F.
6. 2005 CAS Paper, at 2.
7. It is possible to estimate parameter risk in an analytical process by using alternative loss distributions from those applied in the baseline analysis. For example, for a life insurance or annuity product, parameter error in expected mortality could be estimated by applying a factor to the underlying table.
8. Anecdotally, the 10 percent chance of a 10 percent loss was arbitrarily derived from the observed underwriting experience in the Property & Casualty insurance industry in 2003. The underwriting experience demonstrated a lognormal distribution with a mean loss ratio of 74.6 percent and a standard deviation of 11.4 percent. The experience showed a 10 percent overall loss occurs at a nominal loss ratio of 89.6 percent, which occurs at the 90th percentile (the 10 percent chance point for the 10 percent loss).
9. 2005 CAS Paper, at 278.
10. *Id.*
11. A put option gives the purchaser the right to sell an asset at a fixed price while the actual market price of the asset could decline. A put option could be thought of as providing downside protection and protection against market losses. Put options are available on individual stocks and broader market indexes such as the S&P 500. If an underlying asset declines in value, a put will increase in value and provide protection against the loss.
12. Robert P. Butsic, *Solvency Measurement for Property-Liability Risk-Based Capital Applications,* THE JOURNAL OF RISK AND INSURANCE, 1994 VOL. 61, NO. 4, 656-690.
13. 2002 CAS Paper, at 327.
14. 2002 CAS Paper, at 308.
15. One aspect of *Dow Chemical v. United States* involved whether the corporate-owned life insurance contracts owned by Dow were "mortality neutral." While risk transfer was not directly at issue in the case, the trial court did find sufficient mortality risk. *See Dow Chem. Co. v. United States* (Dow I), 250 F. Supp. 2d 748 (E.D. Mich. 2003); *Dow Chem. Co. v. United States* (Dow II), 278 F. Supp. 2d 844 (E.D. Mich. 2003). However, the case was overturned on appeal to the 6th Circuit. 435 F.3d 594 (6th Cir. 2006), cert. denied 127 S. Ct. 1251 (2007). In their opinion, the Sixth Circuit commented, "This review of the cases demonstrates that a "100% retrospective adjustment mechanism" requirement simply cannot be discerned from the past COLI-plan cases. In fact, a rule that permitted a COLI plan to be deemed mortality neutral only upon proof that "every dime of mortality profit" is eliminated would outright conflict with the facts of two of the three cases. Therefore, the district court erred by imposing such a high hurdle as a prerequisite to finding that Dow's plans were designed to neutralize mortality gains." While the Dow decision was in the context of the deduction of policy loan interest, it illustrates that even a demonstrable amount of risk transfer may not be enough to meet a given tax or accounting standard.

Selected Insurance and International Tax Considerations for Investors in Life Settlement Businesses

by Frederic J. Gelfond

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The life settlement industry continues to evolve. Certainly, for life insurance contract owners who have an immediate need for cash or no longer have a reason to maintain their policies, selling their policies to investors who are willing to pay more than a contract's cash value represents an alternative to surrendering a contract or taking out policy loans.[1] And, for investors who can develop reliable actuarial models and establish long-term business processes, this option presents a means of diversifying a portfolio with noncorrelated assets.

At the same time, the nature of this business, in which investors seek to profit purely from the poor mortality experience of selected insureds, has caused some to question whether the underlying concept of the life settlement industry comports with notions of insurable interest. Even though the industry responds to an identified need, some of these concerns have been exacerbated as the result of practices that have developed in which some investors seek to "create inventory" by facilitating the initial purchase of life insurance contracts by unrelated parties. In those cases, the general expectation is that the unrelated insured will transfer the policy to the investor when the contract contestability period terminates.[2]

In addition, the secondary market for life insurance has not yet matured, resulting in instances of inefficient pricing. Moreover, while pricing will typically reflect the investor's desired return, selling policyholders often will not factor in the intangible value of a policy to his or her beneficiaries. Both of these factors have resulted in concerns that, in some circumstances, policyholders may sell their contracts for less than their true value.

Industry participants reconcile many of these concerns about the business itself by relying on state licensing and

other regulatory oversight that seek to ensure consumer protection. So, even though issues continue to be raised in this arena, and there remain several practical barriers to entry, it is a business that has been growing exponentially. In fact, billions of dollars continue to be made available by investors from all over the world who are looking to acquire existing U.S. life insurance contracts.[3]

Despite the number of willing investors and the frequency with which these transactions are occurring, no "cookie cutter" transaction type, or business structure, is predominant in the industry. That is, there is a variety of participants in terms of form of entity, domestic and foreign locale, degrees of active participation in the operation of the "business," sophistication and needs as to actuarial and business modeling, and expectations regarding buying and holding and securitizing the policies.

Among the more significant drivers of the variation in the structuring, however, is a given investor's identification and understanding of the numerous tax issues that are potentially involved.

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A Round Business in a Square Tax Code

Many of these issues surface because the Internal Revenue Code arguably was not crafted in contemplation of a business involving the trading of existing life insurance policies. That is, there are rules in place that are designed to prevent perceived abuses relative to the original purchase and ownership of life insurance policies by individuals and businesses that are generally able to defer or otherwise exclude income from their contracts; *e.g.*, the interest deduction limitation rules set forth in section 264.[4] Yet, it is questionable how, if not whether, many of these rules should be applied in the context of a business operating in a secondary market in which the income from death benefits is generally subject to tax.

For example, the general rules governing the purchase, holding and maturity of a life insurance contract provide for the deferral of income attributable to cash value build-up in a policy. Lifetime distributions of cash value are subject to tax only to the extent that the amount actually received by the policyholder under the contract exceeds the amount paid for the contract.[5] Amounts received upon the death of the insured are excludable from income altogether,[6] unless the contract had previously been the subject of a transfer for value.[7] In the latter case, only the portion of the death benefit that reflects the "cost" of the contract to the policyholder would be excluded from taxable income.[8]

Premiums paid for a contract generally may not be deducted from taxable income.[9] Moreover, except in some very limited circumstances, policyholders may not deduct interest paid in connection with a loan incurred with respect to the policy.[10] These rules reflect an attempt by Congress to limit taxpayers' ability to deduct amounts incurred in connection with the generation of tax-deferred or tax-free income.

In the case of a life settlement business, all the policies are acquired in a purchase transaction that is subject to the above transfer for value rule.[11] Hence, all the income in excess of the cost of the policies is includible in taxable income. In addition, the policies acquired in a life settlement transaction are typically managed in such a way as to keep the cash values in the policies as low as possible without causing the contract to lapse. That being the case, the rationale for the above rules limiting the deductibility of interest is arguably diminished in this context. Nevertheless, one could likely anticipate that there would be a challenge to a position that the interest deduction limitation rules do not apply. Contrast this with a business involving some other form of taxable investment, in which case there would be no general prohibition on the deductibility of interest.

Thus, to the extent that a life settlement business model involves the use of debt to fund the purchase and maintenance of policies, which many of them do, the associated interest expense will likely not be deductible. On the other hand, the transfer for value rule, referred to above, permits the policyholder to include in the cost of the policy that may be excluded from income, interest expense that was otherwise disallowed as a current deduction. In effect, the policyholder may capitalize, rather than currently deduct, this otherwise disallowed interest expense for the purpose of measuring the taxable portion of death proceeds.

This capitalization-type rule for interest expense is specifically available with respect to contracts issued after June 8, 1996.

It should also be noted that, in the event a death benefit is received under a contract, it would be reasonable to assume that the portion of the overall interest expense that may be included in the cost of the contract is limited to the amount of interest paid in connection with that particular policy. As such, in the event that an entity receives taxable income upon the death of an insured, and covenants in a loan agreement require payments of cash receipts to be applied first towards the paydown of loan principal (which is a fairly common requirement), it is possible that the entity will have taxable income, but no cash to pay the tax.

Another practical issue here is how the entity's aggregate debt should be allocated to each policy, particularly if borrowed funds are used to finance other aspects of the business.

Uncertainty also reigns in this arena as a result of what it appears the Internal Revenue Service (IRS or Service) believes to be a difference between the concepts of investment in the contract and basis. As noted above, investment in the contract is essentially equal to the premiums and other consideration paid for a contract less amounts received under the contract that were not included in taxable income.[12] This concept is used for measuring the portion of lifetime distributions from a contract that are excludable from taxable income; and hence, gains that must be included.

The transfer for value rules base the cost that may be excluded from income upon the receipt of taxable death benefits on the consideration, premiums, and other amounts paid for a contract.

In LTR 9443020, however, the IRS took the position that the adjusted basis of a life insurance contract sold by an individual insured to a viatical settlement company[13] must be reduced by the sum of the cost of insurance protection provided under the contract.[14] It is unclear whether the IRS would require a similar reduction in basis for a life settlement company as it mandated in LTR 9443020 for an original purchaser. In any event, it would appear that such position is not consistent with the "basis-type" notions set forth under the Code provisions for measuring gain from a contract that do not require any reduction for incurred costs of insurance. It also appears to be a tenuous position in light of several judicial authorities that arguably rebut the early 1900s case law on which the IRS relied in rendering LTR 9443020.

This issue is less important for a life settlement company that intends to hold all of its contracts until maturity, but it is meaningful for those entities that re-sell policies. To that end, it is also important to note that the rule that deals with the capitalization of disallowed interest under the transfer for value rule applies in the case of amounts received upon the death of an insured.

The provision, however, does not state that it also applies in the case of a sale of a contract. In the 1994 letter ruling, the IRS recognized a distinction between amounts received upon the death of an insured and the proceeds of a sale. To sustain an argument that the disallowed interest should be capitalized in a future sale, one would likely need to develop a position based on general tax principles, as opposed to the specific insurance tax rules.

Another key issue for investors is whether amounts received upon the death of an insured, as well as amounts received upon the re-sale of a policy, should be treated as ordinary or capital income. The weight of authority would appear to suggest that amounts received upon the death of an insured is ordinary income. Capital treatment would require the sale or exchange of a capital asset. Although an insurance policy represents a capital asset, one would nevertheless need to demonstrate that a payment of a death claim via operation of the contract is a sale or exchange.[15]

In the event of the sale of a contract, assignment-of-income theorists might posit that at least a portion of the sales price is for the cash value account that transfers with the policy. The portion of the cash value that exceeds the policyholder's investment in the contract, if withdrawn from the policy, would be subject to tax as ordinary income. On the other hand, it may be possible to support capital gain treatment for the portion of the re-sale price that exceeds the cash value.

To sustain an argument that the disallowed interest should be capitalized in a future sale, one would likely need to develop a position based on general tax principles, as opposed to the specific insurance tax rules.

What if there is a loss? Over the years, IRS employees have made public statements—though not in formal guidance—that one cannot recognize a loss with respect to a life insurance contract. In their comments, they stated that the position assumes that the acquisition of a life insurance contract is a personal expense. A life settlement company could suffer a loss on a contract as the result of a re-sale, a contract surrender or an insured who lives beyond his or her life expectancy. It is not clear whether the IRS would seek to deny a life settlement company the ability to recognize a loss under any of these circumstances.

The above items represent just a few of the many domestic tax issues that add an element of uncertainty to the life settlement arena. Because, in many cases, these items could have a significant impact on the economics of a life settlement business, many domestic and foreign investors seek to set up structures in offshore jurisdictions where the computation of taxable income is less complex and does not involve limitations on the current deductibility of interest, premiums, and other expenditures that may be disallowed or capitalized under U.S. tax law.

Sailing Away

Certainly, as is the case with investments in any type of asset in an offshore vehicle, among the biggest considerations of foreign investors, as well as domestic investors setting up offshore entities, are their exposure to U.S. and foreign withholding taxes, and, depending on the ju-

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risdiction, different treaty and other rules that might be involved; as well as differing tax rates and means of determining taxable income.

Foreign Investors

In conducting this type of planning, foreign investors will first need to determine which tax regime will apply. For example, if the income to be generated is deemed to be business income, and the business is conducted in the United States, tax will be imposed on net income that is sourced in the United States and will be calculated under the same general tax rules that are applicable to domestic taxpayers on their U.S. income.

More precisely, a foreign entity doing business in the United States is subject to U.S. tax on net income effectively connected with the conduct of this trade or business in the United States. The effectively connected net income will be subject to tax at graduated rates up to the highest federal corporate tax rate of 35 percent.[16]

If the business income is foreign source, it would generally not be taxable under U.S. tax rules.[17]

If the business is not conducted in the United States, but the income has a U.S. source, then there could be a 30 percent withholding tax on amounts distributed from the United States to a foreign jurisdiction.[18] Similarly, if the income is deemed to be investment income, as opposed to business income, the income would be subject to a 30 percent withholding tax if the income is considered to be "fixed or determinable annual or periodical gains, profits and income" (FDAP) and the income is considered U.S. source.[19]

The presence of a tax treaty between the United States and the foreign jurisdiction, and the terms of that treaty, could also have an impact on the taxation of the income; *i.e.*, whether the U.S. tax rules will apply to the calculation of income and, if not, whether the income will be subject to withholding.

If the income is investment income, it could qualify for lower withholding rates under the relevant treaty. In the context of a life settlement transaction, this could occur, for example, if the death benefits fit within a treaty's "other income" article. In many (but not all) cases, only the residence country is allowed to tax income not otherwise covered by the treaty.

To summarize, among the key factors in determining the taxation of a life settlement business involving foreign investors are: where the income is sourced; whether the income is business income or investment income; and whether the structure involves payments into a jurisdiction with which the United States has a tax treaty and, if so, whether that treaty provides relief from the normal U.S. tax rules.

A taxpayer is concerned about these issues as they will determine the tax rates, if any, that the income will be subject to, the manner in which taxable income will be determined, the timing in which the income will be includible in taxable income, and whether distributions of cash will be subject to withholding.

Several books can be written on each of the above concepts—and many already have been—but there are a number of additional issues that must be managed in the context of a life settlement arrangement involving a foreign entity.

For example, the question of where income is sourced is not so simple as merely looking at where a life insurance policy or the issuing insurance company is located. Rather, one may be required to look at the type of income that is being paid. For example, the source may be deemed to be different depending on whether the subject income involves the payment of a death benefit, a distribution during the lifetime of the insured, or the proceeds of a re-sale. Of these types of income, most pertinent in the case of life settlement companies is the characterization of death benefits for this purpose.

Section 865(a) provides that gain from the sale of personal property by a nonresident shall be sourced outside the United States. The term "sale" includes "an exchange or *any other disposition*."[20] Thus, if a life insurance policy is deemed to constitute personal property, [21] the payment of death benefits on a life insurance policy is a "disposition" of personal property. And, if section 865(e)[22] is inapplicable, then one could argue that the gain ought to be treated as foreign-source income in the hands of a foreign entity.

Support for treatment of the payment of death benefits as a disposition of a policy can potentially be found in various authorities interpreting section 1001, which provides rules for computing gain from the sale, exchange, or other disposition of property,[23] as well as common definitions

of the term "disposition." A counterargument could be made, however, that relies on one of two revenue rulings that considered payments out of insurance contracts to be FDAP that is subject to 30 percent withholding.

As a preliminary matter, it should be noted that the domestic trade or business concept is roughly parallel to the treaty trade or business concept.

The first of the rulings, Revenue Ruling 64-51, did not deal with the section 865 source question, as that section had not yet been enacted. In any event, the facts set forth in the ruling contained an assumption that the income was U.S. source.

The second ruling, Revenue Ruling 2004-75, found that payments of cash value on surrender were FDAP for withholding purposes. It did not, however, address payments of death benefits.

In reaching its conclusion, the ruling analogized the cash value surrender payments to interest and dividends, and hence arguably reached the correct result. Mortality payments, however, are not as closely aligned to the investment nature of distributed cash value.

Even if the above rulings had addressed the issue, it is not certain that they would have concluded that death benefits constituted FDAP. That is, regulations provide a description of items of income that are not FDAP.[24] This provision states that "Gains derived from the sale of property" are not FDAP. The preamble to these regulations provides that "the IRS and the Treasury believe that the statute contemplates very few exceptions to the concept of FDAP, and the only clear exception is for gain from the disposition of property."[25]

For reasons similar to those discussed above relative to section 865, one could also argue that the payment of death proceeds is a disposition and hence is not included in the definition of FDAP. In light of the holding in Revenue Ruling 2004-75, however, it is less clear whether one could sustain such an argument relative to the portion of a death benefit payment that reflects the cash value at the time of the death claim.

As discussed above, another key issue is whether the activities are an investment activity or a business. As further discussed, if it is an investment activity, regardless of how actively it must be managed, the withholding tax regime would apply. This is significant in this context, as the operation of a life settlement business requires active participation in the identification, acquisition, and administration of each individual contract.

If it is a business activity, then the question is whether the income is effectively connected with the conduct of a U.S. trade or business and whether it qualifies as business profits under a treaty.

A foreign entity will be subject to U.S. tax, as though it were a domestic company, on income that is effectively connected with the conduct of its U.S. trade or business.[26] Thus, the initial question becomes whether the entity is engaged in the conduct of a U.S. trade or business. Adding to the complexity is the fact that there is no comprehensive definition of the term "trade or business," even in the domestic context. The relevant concepts have evolved judicially in the course of cases with many different fact patterns. In general, however, a trade or business entails a profit-oriented, non-investment activity that is regular, continuous, and considerable.[27]

Under this vague standard, various cases and rulings have held that even sporadic or isolated activity in the United States is sufficient to cause a foreign entity to be treated as conducting a U.S. trade or business.[28] This is particularly true when the foreign entity is engaged in a trade or business outside the United States.

As a preliminary matter, it should be noted that the domestic trade or business concept is roughly parallel to the treaty trade or business concept. In a non-treaty scenario, however, U.S. tax is only imposed if the income is effectively connected to a U.S. trade or business. In the treaty context, it is imposed only if the income is attributable to a permanent establishment. [29]

Domestic Investors

Domestic investors will generally be able to defer their recognition of income from an investment in an offshore vehicle unless the entity is characterized as a controlled foreign corporation (CFC). A CFC is an entity in which more than 50 percent of either the combined voting power of all classes of stock or the total value of the stock is held by U.S. shareholders for one or more days during the taxable year. If the entity is a CFC, then each of the U.S. shareholders that owns 10 percent or more of the CFC

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stock will be subject to current tax on its share of "Subpart F income" regardless of whether the income is distributed. The amount to be recognized will be characterized as a deemed dividend.

Those U.S. shareholders that own less than 10 percent of the stock will also be subject to tax if the foreign entity is a passive foreign investment company (PFIC).

Subpart F income is comprised of two broad classes: income from the insurance of U.S. risks and foreign base company income. In the case of a life settlement business, the first category does not apply, but the latter category may. Foreign base company income is further categorized into five different general classes, with the only potentially relevant class being foreign personal holding company income (FPHCI). FPHCI is composed of several specifically identified types of passive income; *e.g.*, rents, dividends, interest, royalties, annuities, and a number of other listed items, including "income equivalent to interest."

Regulations under these rules state that income equivalent to interest includes investments in which the return predominantly reflects the time value of money; arrangements that involve compensation for the use or forbearance of money but that are not treated as interest; and other items.

Death benefits from an insurance contract are not one of the listed items of FPHCI, and they have not been specified in the items listed in the regulations. The question has been raised, however, as to whether a death benefit is "income equivalent to interest."

A death benefit is a payment based on the mortality of the covered individual. Although premium amounts paid to an insurance company may reflect, to an extent, the insurance company's investment return based on a time horizon that considers the insured's life expectancy, they represent only one component of the "return" that is promised to the policyholder.

The IRS addressed this issue, as well as the question of whether amounts received upon a surrender of a contract constitute income equivalent to interest. In Field Service Advice Memorandum (FSA) 199950006, the IRS said that neither death benefits nor amounts received upon a surrender are income equivalent to interest. As set forth in the FSA:

> Death benefits are not compensation for the use or forbearance of money and do not reflect the time value of money. Consequently, they are not interest income;…
>
> [S]urrender withdrawals are not interest income (or the equivalent thereof) . . . because they were not compensation for the use or forbearance of money…

Death benefits do not appear to fit within any of the other categories of FPHCI, unless they are gain from the sale of property that does not give rise to any income. The regulations are quite broad, covering the sale or exchange of any property unless excluded (and life insurance policies are not excluded). This regulation is arguably too broad, and, even if applicable to a sale of the policy prior to death, it may not apply to the payment of death benefits at death. Therefore, it would appear that absent further guidance to the contrary, one could reasonably argue that death benefits will not result in the creation of foreign base company income.

If at least 75 percent or more of a foreign entity's income is passive income, or 50 percent or more of its assets are held for the product of passive income, a company will be characterized as a passive foreign investment company. The determination as to whether income will be deemed to be passive for this purpose depends on whether the income would be FPHCI. As set forth in section 1297, "passive income" is "any income which is of a type which would be foreign passive holding company income."

As such, if death benefits, or even cash value build-up, are not characterized as FPHCI, then the entity will not likely be treated as a PFIC provided the policies are intended to be held to maturity (although it could be if the policies are held for sale).

Conclusion

Because the life settlement industry is relatively new, there has likely been little of the IRS audit activity that would cause a brighter light to shine on many of the issues discussed above. There are indications, however, that the IRS has recently been studying the various types of life settlement transactions and structures. Perhaps, in the not too distant future, taxpayers will be able to see IRS guidance on at least some of these issues. ◂

Special Note: The author thanks Deloitte Tax LLP principal, Richard J. Safranek, for his valuable insights and comments on the international insurance tax issues discussed herein.

End Notes

1. Investors are willing to pay more than cash value, as the return they expect is based on assumptions regarding a contract's maturity that were not reflected in the initial pricing of the policy. The price they are willing to pay is typically based on a discounted value of the death benefit claim that is expected to occur earlier than was originally anticipated by the issuing life insurance company. This circumstance might occur, for example, if an insured suffers a health issue that did not exist at the time the policy was issued by the insurance company.
2. This outgrowth of the life settlement industry is often referred to as "stranger-owned life insurance." While there is no uniform use of the term, the practice described above is sometimes referred to as "premium financing."
3. U.S. contracts are particularly attractive because of the requirement that such contracts contain a meaningful net amount at risk above the amount of the contract's cash value. This net amount at risk is the subject of the "arbitrage" that the investors attempt to undertake through their purchase of the policies.
4. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (Code).
5. Section 72. More precisely, policyholders are not subject to tax on returns of their "investment in the contract." Such amount is essentially equal to the premiums paid into the contract less any distributions that were not included in taxable income. Lifetime distributions from life insurance contracts that are characterized as modified endowment contracts pursuant to section 7702A are subject to a different rule. Such amounts are taxed on an income-first basis.
6. Section 101(a)(1).
7. Section 101(a)(2). This general rule also does not apply in the case of an employer-owned life insurance policy that does not fit within one of the exceptions set forth in section 101(j).
8. *Id.* The amount that is excluded may not exceed the value of the consideration paid for the contract plus premiums and other amounts subsequently paid by the transferee. The "other amounts" include interest payments that are disallowed as a deduction pursuant to section 264(a)(4).
9. Section 264(a)(1).
10. Section 264(a)(2) through (4).
11. Some have attempted to develop a business model intended to avoid application of the transfer for value rule.
12. Section 72.
13. A viatical settlement company is analogous to a life settlement company in that it involves the purchase of existing life insurance contracts. The contracts that are the subject of a viatical settlement, however, involve insureds that are terminally or chronically ill.
14. More precisely, the Service said: "The adjusted basis of Taxpayer's contract is equal to the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (*e.g.*, dividends) received under the contract that have not been included in gross income." Note that, although the Service cited the section 72(e) in an apparent attempt to reference the definition of investment in the contract, the ruling did not replicate the language set forth in section 72(e) that includes, in the definition, premiums and "other consideration" paid for the contract.
15. Alternatively, one could foresee an argument being made under section 1234A that the proceeds are attributable to a "cancellation, lapse, expiration, or other termination" of a right with respect to a capital asset, and hence, subject to capital gain treatment.
16. In addition, pursuant to section 884, a dividend equivalent branch profits tax of 30 percent can be imposed, in certain circumstances, when the profits are repatriated to the home office for redemptions or other purposes. In general, these branch taxes are intended to replicate the withholding taxes that would be imposed if a U.S. subsidiary paid dividends or interest to its foreign parent.
17. Section 864(c).
18. Regulation section 1.1441-2(b).
19. IRC §881(a).
20. IRC §865(i)(2).
21. Life insurance has long been recognized as personal property. *See, e.g., Lucas v. Alexander*, 279 U.S. 573 (1929).
22. Section 865(e)(2) provides that if a foreign entity maintains an office or other fixed place of business in the U.S., income from the sale of personal property attributable to such office or other fixed place of business shall be sourced in the U.S.
23. *Helvering v. Roth*, 115 F. 2d 239 (2d Cir., 1940); *Herbert's Estate v. Commissioner*, 139 F. 2d 756 (3d Cir., 1943); *Elverson v. Commissioner*, 122 F.2d 295 (2d Cir. 1941). These cases held that when a lender receives a cash payment in extinguishment of debt, he is treated as having disposed of the property. *See also, Hatch v. Commissioner*, 190 F.2d 254 (2d Cir. 1951), which found that an employer's payment on a claim for a death benefit constituted a disposal of the claim at a profit by the deceased's beneficiary.
24. See regulation section 1.1441-2(b)(2).
25. TD8734, 62FR53387, October 14, 1997 at 26.
26. IRC §864 (c).
27. *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987).
28. *Johansson v. United States*, 336 F. 2d 809 (5th Cir., 1964); Rev. Rul 67-321, 1967-2. C.B. 470, Rev. Rul 70-543, 1970-2 C.B. 172.
29. Three different tests are used to determine whether a permanent establishment exists. One test looks at the assets of an entity maintained in the treaty jurisdiction, such as a branch, an office, or a store. A second examines the acts of an agent, broker, partner, or subsidiary. The third analyzes the activities carried on by the enterprise in the treaty country. Among the factors that have been key in making the determination are the active conduct of business and continuity of activities.

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Effective Date and Statutory Reserves Capping Issues under Actuarial Guideline XLIII

by Peter H. Winslow

This issue of *TAXING TIMES* includes an article which provides an excellent summary of tax issues that arise from the adoption of VACARVM by the National Association of Insurance Commissioners (NAIC)[1] as well as an American Council of Life Insurer's (ACLI) update of its dealings with the Treasury Department (Treasury) on the same issue.[2] VACARVM is now designated as Actuarial Guideline XLIII (AG 43). The above referenced article makes the important point that, despite its retroactivity for statutory purposes, AG 43 probably will have only prospective effect for tax purposes. Both the article and the ACLI Update note that, regardless of whether the Stochastic Excess will be considered part of CARVM reserves for tax purposes, it may be included in the statutory reserves cap for purposes of the three-way test under I.R.C. § 807(d)(1). These points deserve some elaboration.

Does AG 43 apply to all contracts issued in 2009?

Under I.R.C. § 807(d)(3), the tax reserve method that must be used for variable annuity contracts is the Commissioners' Annuities Reserve Valuation Method (CARVM) prescribed by the NAIC in effect on the date of the issuance of the contract. Implementation of this statutory rule has resulted in disputes between the Internal Revenue Service (IRS) and life insurance companies where the NAIC has adopted actuarial guidelines with retroactive effect. IRS auditors generally have taken the position that a newly-adopted actuarial guideline cannot apply for tax purposes to contracts issued prior to the year the guideline was adopted. As support for this position, IRS auditors cite a technical advice memorandum that currently is being challenged in the U.S. District Court in a tax refund suit.[3] Life insurance companies have argued that an actuarial guideline should apply retroactively when the new method is used for statutory reserves and it was one of several permissible interpretations of CARVM at the time the contract was issued.[4]

There does not appear to be a major dispute on this issue as a result of the NAIC's adoption of AG 43. The IRS is likely to take the position that AG 43 should not be used for contracts issued prior to 2009, and taxpayers are equally likely to accept this interpretation, at least for most pre-2009 contracts. This is because—prior to the adoption of AG 43—the NAIC had clear guidance on the interpretation of CARVM in AG 34 and AG 39 that was required to be used for the tax reserve method under I.R.C. § 807(d)(3). There is a lingering issue, however, relating to contracts subject to AG 43, but issued prior to the adoption of AG 34 or AG 39. It could be argued that AG 43 should be used for these contracts because there was no NAIC-prescribed interpretation of CARVM at the time they were issued, and AG 43, at least in theory, was one of several permissible interpretations. Therefore, because AG 43 will be used for statutory reserves for these contracts, it is arguable that it also should be used as the tax reserve method. Nevertheless, it appears from comments sent to the Treasury and the IRS by the ACLI on Oct. 24, 2008, that the industry does not intend to press this issue. Perhaps, this issue will be revisited after the pending litigation on the retroactive application of AG 33 is resolved.

Assuming that AG 43 will not have a retroactive effect, there still remains an open issue as to whether it will apply to all contracts issued in 2009 on the basis that it was adopted prior to 2009 by the NAIC and effective for all contracts issued in that year. Other potential approaches could be that AG 43 will apply to contracts issued after Sept. 24, 2008, the date AG 43 actually was adopted by the NAIC, or only to contracts issued on or after Dec. 31, 2009, AG 43's effective date. There is no

clear answer to this question in the statute or legislative history, but preliminary indications are that the IRS may conclude that AG 43 will apply for tax purposes to all contracts issued in 2009. This is the most reasonable and administrable result, and has been recommended by the ACLI.

Will the Stochastic Excess portion of AG 43 reserves be included in the statutory reserves cap?

A major unresolved issue is whether the Stochastic Excess portion of AG 43 reserves will be recognized as part of CARVM reserves for tax purposes. This commentator believes that it should be,[5] but, it is possible, if not likely, that the Treasury and the IRS will reach a contrary conclusion. Assuming that it is concluded that the Stochastic Excess will not be included as part of the CARVM tax reserve method under I.R.C. § 807(d)(3), the next question is: will it be considered part of statutory reserves for purposes of determining the limitation on deductible tax reserves? This can be an important consideration if the amount of tax reserves computed under AG 34 and AG 39 for a pre-2009 contract is greater than the statutory reserves computed under the Standard Scenario in AG 43.

The better answer to this question is that a contract's portion of the Stochastic Excess allocated in accordance with AG 43 should be included in statutory reserves for the contract. This conclusion is supported by the statutory language, its legislative history and the tax policy considerations underlying the statutory provisions. Under I.R.C. § 807(d)(6), statutory reserves include the aggregate amount set forth in the Annual Statement for a contract "with respect to" the reserve items described in I.R.C. § 807(c). This statutory language incorporates two basic principles. First, reserves held on the Annual Statement do not themselves have to be deductible as insurance reserves described in I.R.C. § 807(c) to be included in statutory reserves. Had this been the test, the statute would have limited statutory reserves to I.R.C. § 807(c) items. The second principle is that there must be a nexus between an I.R.C. § 807(c) insurance reserve and a non-deductible Annual Statement reserve for it to be included in statutory reserves. That is, the reserve must be held "with respect to" an insurance reserve described in I.R.C. § 807(c). This nexus seems to be present for the Stochastic Excess portion of CARVM reserves under AG 43. After all, the NAIC has prescribed the Stochastic Excess as part of the basic CARVM minimum reserve for a variable annuity contract. This conclusion is supported by the legislative history that reflects Congress' intent to include deficiency reserves in the statutory reserves cap.[6] As in the case of the Stochastic Excess under AG 43, the minimum reserve required under the Commissioners' Reserve Valuation Method (CRVM) includes deficiency reserves even though they are not deductible for tax purposes. In both cases, the NAIC has established the requisite nexus between the nondeductible reserve and the I.R.C. § 807(c) insurance reserve to satisfy the criteria for statutory reserves under I.R.C. § 807(d)(6).

A major unresolved issue is whether the Stochastic Excess portion of AG 43 reserves will be recognized as part of CARVM reserves for tax purposes.

Tax policy considerations also support this conclusion. When it was originally enacted as part of the Deficit Reduction Act of 1984 (1984 Act) the definition of statutory reserves was found in former I.R.C. § 809, which imposed an "add-on tax" on mutual life insurance companies determined by reference to their "equity base." Statutory reserves were a factor taken into account which had the effect of increasing the equity base and, therefore, the add-on tax imposed. Congress intended a broad interpretation of statutory reserves to ensure that the equity base would not be reduced. As a result, there is little doubt that the IRS would have concluded that, under former I.R.C. § 809, an NAIC-required reserve like the Stochastic Excess would have been required to be included in statutory reserves.

Similar considerations apply to the tax policy under I.R.C. § 807. Congress' primary objective in enacting the tax reserve rules in the 1984 Act was to create a level playing field by providing that life insurance companies would obtain essentially the same reserve deductions regardless of the states in which they were doing business. There was an exception to this equal deduction rule. Congress determined that it was not consistent with the level-playing-field principle to permit an insurer to obtain a tax reserve deduction for reserves that were not actually held on the Annual Statement because such a company would obtain a competitive advantage if its surplus were not reduced by the reserves. An overly narrow interpretation of statutory reserves would defeat

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Congress' desire to provide a level playing field by denying companies a tax reserve deduction enjoyed by their competitors even when, in fact, they hold reserves somewhere on the Annual Statement.

Will the 10-year spread rule of I.R.C. § 807(f) apply to the change to AG 43?

I.R.C. § 807(f) provides for certain reserve adjustments where there has been a change in the basis of determining reserves for contracts issued prior to the year of change. There are two basic rules in I.R.C. § 807(f). First, the change in basis is delayed for tax purposes for one year and tax reserves continue to be computed on the old method for these pre-change-year contracts for the taxable year in which the change occurs. Second, the difference between the ending tax reserve for the year of change computed on the new basis and the ending tax reserve computed on the old basis is spread ratably over 10 years.

It generally is believed that this 10-year spread rule should not have much impact upon the adoption of AG 43 because AG 34 and AG 39 should continue to apply for tax purposes to contracts issued prior to 2009. However, there is one nagging unresolved issue that could come into play. Since the enactment of the 1984 Act, the life insurance industry has wrestled with the question of whether a change in statutory reserves is a change in basis of determining reserves subject to I.R.C. § 807(f) even if the amount of the uncapped federally prescribed reserves in I.R.C. § 807(d) does not change. There has been no direct guidance from the IRS on this issue although it arises frequently when Annual Statement reserve assumptions change. Resolution of this issue involves analysis of case law and rulings relating to changes in method of accounting under I.R.C. § 446. The IRS and the courts have concluded that the 10-year spread rule will apply if the change in computing tax reserves would have been considered a change in method of accounting but for the special I.R.C. § 807(f) rule.[7]

It is a close question whether a change in method of accounting is involved when the statutory reserves cap, but not the federally prescribed reserve, is recomputed. It could be argued that the impact on reserves from a change in the cap affects the timing of the reserve deductions and, therefore, is in the nature of a change in method of accounting.[8] An equally persuasive argument could be made that a change in method of accounting is not involved unless the computation of the federally prescribed reserves is adjusted. Under this approach, a change in the statutory reserves cap that occurs solely by reason of a change in Annual Statement reporting is a change in external facts not subject to the change-in-method-of-accounting rules.

Although resolution of this issue could go either way, this commentator believes that the IRS likely will conclude that I.R.C. § 807(f) does not apply. The most likely scenario will be that AG 34 and AG 39 reserves will be higher than the AG 43 reserves held on the 2009 Annual Statement. If the IRS were to conclude that I.R.C. § 807(f) applies, we could have the anomalous result that statutory reserves for 2009 would be computed using the old AG 34 and AG 39 method for purposes of the cap even though they are higher than the reserves actually held on the 2009 Annual Statement. In its October 24 letter, the ACLI recommended that I.R.C. § 807(f) not apply in these circumstances.

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End Notes

1 Adopted on Sept. 24, 2008.

2 *See* E. Robbins, M, LeBoeuf and V. Akin, *Tax Aspects of VA CARVM (aka Actuarial Guideline XLIII)*, p. 1 and *ACLI Update Column*, p. 29 of this issue.

3 TAM 200328006 (Mar. 20, 2003). *See* P. Winslow, *IRS's Position on Retroactivity of Actuarial Guidelines to be Tested in Court, TAXING TIMES*, VOL. 4, ISSUE 1, February 2008.

4 *See* P. Winslow and S. Hotine, *IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date, TAXING TIMES,* VOL. I, ISSUE 2, September 2005, for a more complete discussion of this issue.

5 *See* P. Winslow, *The Tax Reserve Method Should Be PBR Once It Is Adopted by the NAIC, TAXING TIMES,* VOL. 4, ISSUE 3, September 2008.

6 *See* S. Mitchell and P. Winslow, *The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves, TAXING TIMES,* VOL. 2, ISSUE 2, September 2006.

7 Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life and Accident Ins. Co. v. United States*, 90-1 USTC ¶ 50,010 (M.D. Tenn. 1989).

8 Treas. Reg. § 1.446-1(e)(2)(ii)(a).

A Practical Guide for Determining Whether a Section 338(h)(10) Election Should Be Made for a Target Insurance Company

by Lori Jones

In March 2006, the Internal Revenue Service (IRS) finalized regulations which provide helpful rules for determining the likely tax consequences of a section 338(h)(10)[1] election on the disposition of an insurance company.[2] T.D. 9257 (April 7, 2006). However, as discussed below, despite the helpful guidance, there are a number of considerations—both tax and nontax—which must be taken into account before deciding on making the election. These considerations begin with the basic question as to whether the respective parties, the Buyer and the Seller, will have a better tax answer with or without an election. Before discussing the evaluation process, a summary of the basic rules is necessary.

Stock Sale Without Section 338(h)(10) Election

If a Buyer purchases 100 percent of the stock of a Target insurance company without the election, the Seller's gain or loss is determined by comparing the Seller's aggregate stock basis to the amount realized on the sale. The tax basis of Target's assets stays the same as it was prior to the sale. All of Target's tax attributes remain with Target although their use by the Buyer or the Buyer's consolidated group may be limited under various Code sections, such as the limitation on the use of loss carryovers and built-in loss under section 382, or the section 1504(c)(2) inability of a Target life insurance company to immediately join in a new life/nonlife consolidated group. The tax basis in Target's assets includes the unamortized balance of specified policy acquisition expenses under section 848 as well as the remaining balance of any existing section 197 intangible in the hands of Target. These amounts continue to be amortized on the same amortization schedule utilized by Target prior to the sale. On the other hand, the Buyer has a tax basis in Target stock equal to the purchase price plus capitalized expenses. In the event of a stock purchase when Target is a member of a consolidated group, Target retains tax liability for all consolidated return years for which it was a member under Treas. Reg. § 1.1502-6.

Stock Sale With Section 338(h)(10) Election

In contrast, if a section 338(h)(10) joint election is made by the Seller and the Buyer for insurance company Target, the election treats "Old" Target's assets as having been sold to "New" Target pursuant to an assumption reinsurance transaction and disregards the stock sale for federal income tax purposes.[3] Old Target recognizes gain or loss on the deemed sale of its assets, which includes those assets deemed transferred as consideration in the hypothetical assumption reinsurance transaction, based on the allocation of the "adjusted deemed sales price" (ADSP) among its assets. The deemed sale of assets is followed by the deemed liquidation of Old Target into its shareholder[s].[4] The liquidation may be treated as tax-free pursuant to section 332 if the general rules of that provision are satisfied. In that case, Old Target's tax attributes, such as loss carryovers, remain with the corporation that held 80 percent of the vote and value of its stock. However, if the provisions of section 332 are not satisfied, the liquidation of Old Target into its shareholder will be taxable under section 331 to the shareholder and any remaining tax attributes will be lost.[5] In either case, Old Target's taxable year will close at the end of the day in which the stock sale occurs. In addi-

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tion—even though for most federal income tax purposes New Target will be treated as an unrelated party to Old Target—there are exceptions to this rule. The most important is the exception whereby New Target continues to retain tax liability under Treas. Reg. § 1.1502-6 for years in which it joined another consolidated group.[6]

The assumption reinsurance transaction which is deemed to occur pursuant to section 338(h)(10) is also generally treated in the same manner as an actual assumption reinsurance transaction, with certain exceptions.[7] The regulations provide guidance on how to determine the fair market value of assets deemed transferred in the assumption reinsurance transaction by requiring Old Target to value the amount of its insurance contracts, *i.e.*, insurance in force or ceding commission. The fair market value of the insurance contracts is the amount a willing reinsurer would pay a willing ceding company in an arm's length transaction for the contracts if the gross reinsurance premium for the insurance contracts were equal to the ceding company's tax reserves for the insurance contracts.[8] Old Target will receive a deduction equal to the fair market value of assets treated as transferred for the assumption of liabilities by New Target less the value of the insurance contracts and will have income for the release of the insurance tax reserves. Section 848 will apply as if there is an actual reinsurance transaction so that in most cases Old Target will be able to deduct the remaining amount of its unamortized section 848 balance.[9] On the other hand, New Target must recompute the amount of unamortized specified policy acquisition expenses it receives in the deemed assumption reinsurance transaction and will have a new amortization period beginning with a one-half year amortization in the year of the transaction.

The section 338 regulations contain several rules which are unique to section 338(h)(10) elections for Target insurance companies. First, the regulations address (and eliminate) the problem created if a "negative ceding commission" was paid to New Target and the resulting concern that New Target would have immediate premium income to the extent that the assets received exceeded the assumed insurance tax reserves. The regulations prevent immediate premium income to New Target by stating that the gross amount of the reinsurance premium paid by Old Target to New Target will be deemed equal to Old Target's closing tax reserves.[10] The rule in effect works as a cap because neither party can be treated as transferring or receiving a reinsurance premium that exceeds the tax reserves actually or deemed transferred. If the amount allocable to the insurance contracts is negative, New Target will likely have reduced asset basis as a cost for not having immediate net premium income while Old Target will have a reduced underwriting deduction on the transfer but also will have reduced gain or increased loss on the deemed or actual sale of its assets. Consequently, for Old Target, this rule may result in a change in character from an ordinary deduction in the case of mere reinsurance (subject to Treas. Reg. § 1.817-4(d)) to a capital loss in the case of a section 338(h)(10) election.

Another special rule in the section 338 regulations that does not apply to an actual reinsurance transaction is that certain post-transaction reserve deductions must be capitalized by New Target.[11] This capitalization will often apply only to those situations where the deemed asset sale involves a negative ceding commission.[12] Capitalization is not required for post-acquisition increases in reserves while the reinsurer is under a state receivership proceeding or to the extent the deduction for the reserve increase for a life insurance company is spread over ten years under section 807(f).[13] Other special provisions in the section 338 regulations relate to section 846(e) elections, rules under section 815 regarding policyholder surplus accounts (which may not have much practical impact going forward), and rules regarding section 847 estimated tax payments on unpaid losses.[14]

New Target takes a basis in the assets pursuant to an allocation of "adjusted grossed up basis" (AGUB).[15] Both ADSP and AGUB are basically determined by grossing up the purchase price by the amount of Target's tax reserves plus other liabilities.[16] Allocation of ADSP and AGUB is done on a residual method based on the respective classes of assets. Class VI includes section 197 intangibles, including any value allocated to the insurance contracts but other than goodwill and going concern value. Since these intangibles can generally be amortized over 15 years and usually had no tax basis in the hands of Old Target, the existence of sufficient AGUB to allocate to these intangibles is an important factor in determining whether to make an election under section 338(h)(10). If application of the AGUB rules results in no amount treated as paid for the insurance contracts, it is likely that there is no new section 197 intangible that would be created as a result of the section 338(h)(10) election, thus reducing the benefit to the Buyer from such an election.

Is the Election Beneficial to the Buyer and/or the Seller from a Tax Perspective?

These are the primary questions that should be asked in

order to determine whether a section 338(h)(10) election is preferable. Of course, this assumes that both parties are at least willing to consider making the election since joint consent is required.

1. Is the Seller's basis in Target's stock higher than Target's net inside asset basis?
2. What are the consequences of the deemed asset sale? Is the net asset basis in the assets increased or decreased?
3. What are the consequences of the assumption reinsurance transaction? What is the value of the insurance contracts? What are the expected results under section 848?
4. What is the amount, if any, of Old Target's existing section 197 intangible or New Target's section 197 intangible in the event a section 338(h)(10) election is made? What is the expected utilization of the amortization of the section 197 intangible?
5. Is there any other benefit to a stock sale without a section 338(h)(10) election that should be considered? For example, can any of Target's tax attributes be utilized in a beneficial manner by the Buyer? Is Target expected to increase its tax reserves after the transaction (in a manner that would otherwise be limited under the section 338(h)(10) rules)?

Is the Election Beneficial to Either the Buyer and/or the Seller Taking into Account Tax as Well as any Indemnifications or Purchase Price Adjustments?

1. What indemnifications for Target and Target's consolidated tax liability can be agreed upon between the Buyer and the Seller? (Note that potential liability under Treas. Reg. § 1.1502-6 is not eliminated in either the straight stock sale or the sale with a section 338(h)(10) election.)
2. What indemnifications can be agreed upon dealing with potential tax detriments to the Buyer such as the application of section 848? Is this outweighed by the increase in the section 197 intangibles? Are there any purchase price adjustments related to potential tax benefits to the Buyer or the Seller?
3. What are the expected costs in making sure that any indemnifications are properly implemented?

In all likelihood, the key factor in determining whether the section 338(h)(10) election should be made is whether New Target will receive a new benefit (after any purchase price adjustments and other negotiated factors) from a newly-created section 197 intangible.

End Notes

1 References to section are to sections of the Internal Revenue Code of 1986, as amended.

2 This article does not discuss the potential application of a section 338(g) election to a domestic target because it generally results in a double layer of tax on the stock sale and on the deemed asset sale. A section 338(h)(10) election generally results only in a single layer of tax because the stock sale is disregarded. In addition, this article does not address directly the considerations in determining whether a section 336(e) election to treat the sale as a deemed asset sale and liquidation similar to a section 338(h)(10) election is beneficial. *See* Prop. Treas. Reg. § 1.336-0 to 1.336-4. Note that the section 336(e) election as set forth in recent proposed regulations is not a joint election between the Buyer and Seller but rather an election made solely by Seller.

3 Treas. Reg. § 1.338(h)(10)-1(d).

4 Treas. Reg. § 1.338(h)(10)-1(d).

5 *See, e.g.*, Rev. Rul. 2008-25, 2008-21 I.R.B. 986.

6 *See* Treas. Reg. § 1.338(h)(10)-1(b)(3)(ii).

7 Treas. Reg. § 1.338-11(c).

8 Treas. Reg. § 1.338-11(b)(2). It is unclear how this rule should be interpreted. In most actuarial valuations of insurance in force, the amount of the distributable earnings is based on statutory reserves, which may differ from tax reserves. One way to interpret the rule is to value the insurance contracts and then reduce the amount by the excess of the statutory over the tax reserves. This would likely result in a lower value of insurance in force for tax purposes, as compared to a normal actuarial valuation. On the other hand, one could interpret the rule as requiring the substitution of tax reserves for statutory reserves in determining distributable earnings, which would have the result of increasing the value of insurance in force (because the liability for tax purposes would be lower). The problem with the latter approach is that it probably was not what was intended by the drafters. Thus, until and unless further guidance is issued, the former approach set forth above appears to be the more reasonable interpretation of the regulation. P. Winslow and S. Mitchell, *Valuation of Insurance in Force for Tax Purposes*, T^3: Taxing Times Tidbits, 9 TAXING TIMES, Vol. 1, Issue 3 (December 2005).

9 Treas. Reg. § 1.338-11(f).

10 Treas. Reg. § 1.338-11(c)(2).

11 Treas. Reg. § 1.338-11(d).

12 Treas. Reg. § 1.338-11(d)(4).

13 Treas. Reg. § 1.338-11(d)(2).

14 Treas. Reg. § 1.338-11(e), (g) and (h).

15 Treas. Reg. § 1.338-11(b)(2).

16 Treas. Reg. § 1.338-11(b)(1).

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ACLI Update Column

by Bill Elwell

In past issues of *TAXING TIMES*, The American Council of Life Insurers (ACLI) has reported on its ongoing efforts with the Treasury Department (Treasury) regarding the National Association of Insurance Commissioners (NAIC) reserve modernization efforts. After nearly a decade of work by ACLI and representatives of its member companies, the Society of Actuaries (SOA), the American Academy of Actuaries (Academy), and the NAIC's Life and Health Actuarial Task Force (LHATF), on Sept. 24, 2008, the NAIC adopted a new actuarial guideline for applying the method of computing statutory reserves for variable annuity contracts (AG VACARVM). We appreciate Treasury's and the Internal Revenue Service's (IRS) continuing willingness to discuss the tax implications of AG VACARVM while the modernization effort is underway. The release of Notice 2008-18 earlier this year and the opportunity for input has been very valuable, and ACLI continues the timely consideration of the recently adopted Guideline.

On Oct.10, 2008, ACLI and representatives from the Academy, NAIC, and Affordable Life Insurance Alliance (ALIA) met with representatives from Treasury and IRS to discuss the need for immediate guidance regarding the tax treatment of reserves determined under AG VACARVM because life insurance companies are now preparing for annuity contracts that will be issued in 2009 and planning for the related tax liabilities. Shortly thereafter, ACLI sent Treasury and IRS a letter focusing on the aspects of AG VACARVM that have immediate and significant ramifications to our member companies and requesting that Treasury and IRS issue published guidance before the end of 2008 on three key issues: (1) the effective date of AG VACARVM for tax purposes; (2) the status of the Standard Scenario as a tax deductible reserve under section 807(d) of the Internal Revenue Code;[1] and (3) the limitation based on statutory reserves under section 807(d). ACLI believes it has given Treasury and IRS sufficient information and policy rationales for Treasury and IRS to issue favorable guidance on these issues this year.

Effective Date of AG VACARVM for Tax Purposes Should be 2009

In the meeting and its follow-up letter, ACLI explained that because AG VACARVM has an effective date of Dec. 31, 2009, and it applies to all contracts issued on or after Jan. 1, 1981, for 2009 annual statements, all insurance companies issuing contracts must calculate reserves for these variable annuity contracts in accordance with AG VACARVM.

Section 807(d) requires the use of "CARVM" to compute reserves for an annuity contract. CARVM is the Commissioner's Annuity Reserve Valuation Method prescribed by the NAIC that is in effect on the date of the issuance of the contract.[2] For contracts issued in 2009, companies will determine the tax reserves for these contracts for the first time at the end of the year—Dec. 31, 2009. Because companies determine the tax reserves for a contract at the end of the year, an actuarial guideline that becomes effective during a year should be effective for all contracts issued that year; this treatment is particularly appropriate in this case where NAIC adopted the Guideline before the start of the year in which the Guideline becomes effective.

Consequently, ACLI requested that Treasury and IRS issue guidance that provides that for contracts issued in 2009, AG VACARVM will be the actuarial guideline in effect, and the effective date of AG VACARVM for tax purposes should therefore be 2009.

Standard Scenario Satisfies Requirements in Section 807(d)

ACLI also explained to Treasury and IRS that the AG VACARVM reserve is comprised of the Standard Scenario and Stochastic excess (if any) determined under the Guideline. IRS Notice 2008-18 recognizes that AG VACARVM reserves are determined in two parts, first by computing the Standard Scenario amount and then by Stochastic modeling. The Standard Scenario portion of the AG VACARVM reserve is determined on a contract-by-contract basis and is based on a prescribed interest rate determined by the year of issue of the contract and on standard mortality tables. As Treasury and IRS observed in the Notice, the computation of the Standard Scenario amount resembles the current reserve methodology's computation of the tax reserve. The Notice suggests that Treasury and IRS may conclude that the Standard Scenario portion of the AG VACARVM reserve satisfies the requirements of section 807(d), a conclusion with which ACLI would agree. Although it is ACLI's view that both parts of AG VACARVM satisfy section 807(d), ACLI recognizes that the portion of the reserve determined by stochastic modeling presents a more difficult question for which Treasury and IRS may need more information.

Consequently, ACLI requested that Treasury and IRS issue guidance that provides that the portion of the reserve determined using the Standard Scenario satisfies the

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requirements in section 807(d) as an amount of reserves for the purposes of determining taxable income.

Limitation Based on Statutory Reserves Under Section 807(d)

A life insurance company generally must pay tax on its life insurance company taxable income, which is life insurance gross income less life insurance deductions.[3] The Code authorizes a deduction for the net increase in reserves under section 807(b).[4] The tax reserve for a life insurance contract is the greater of: (i) the net surrender value of the contract, or (ii) the reserve calculated in accordance with section 807(d)(2).[5] This amount, however, can never "exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves."[6] Accordingly, the statutory reserves with respect to a contract operate as a limit on the amount of the contract's life insurance reserves that might otherwise be taken into account in determining a life insurance company's taxable income. The term "statutory reserves" is defined as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)," but does not include any reserve attributable to a deferred and uncollected premium if section 811(c) does not permit the establishment of this reserve.[7] Section 807(c) includes life insurance reserves under section 816(b).[8] The reserves determined under AG VACARVM are "life insurance reserves" under section 816(b).

Section 807(d) therefore sets both a floor and a ceiling on the amount of the reserves to be used in determining income. The floor is the net surrender value of the contract; the ceiling is the amount taken into account for the contract in determining the statutory reserves. With the adoption of AG VACARVM, the NAIC-prescribed method for determining the statutory reserves for variable annuity contracts includes the Standard Scenario amount and the excess (if any) of the Stochastic reserve over the Standard Scenario. The Code requirement that the amount of reserves cannot exceed the amount of statutory reserves provides a limit based on the reserves a life insurance company actually holds. There is no basis in either the statute or the legislative history for adjusting the amount of statutory reserves to exclude the Stochastic reserves. Section 807(d) provides a tax reserve method, with specific parameters and adjustments for determining the amount deductible under section 807(d), subject to a limitation of the amount of the statutory reserves, but not for adjustments to the amount carried as a statutory reserve.

Section 807(d) refers to the amount of reserves "with respect to such contract." AG VACARVM allocates the excess of the Stochastic amount over the Standard Scenario (using prescribed methods) among the contracts to determine each contract's reserve amount. Specifically, AG VACARVM requires that when the stochastic amount is greater than the Standard Scenario amount, it must be allocated to each contract in a manner that reflects the contribution of each contract to the Stochastic excess. Thus, in instances where the stochastic amount exceeds the Standard Scenario amount, the stochastic amount results in a contract-specific reserve determination, so AG VACARVM provides a contract-specific statutory reserve amount for purposes of applying the statutory reserve limit of section 807(d).

While the allocation methodology has implications for federal taxation, understanding which contracts give rise to the stochastic excess also has value for management and regulatory purposes. State regulators, for example, use reserves determined on a contract-by-contract basis in the rehabilitation of a company when valuing policyholder claims against the company in rehabilitation. Similarly, guaranty funds use these reserves in valuing a business for purposes of selling a portion of the business.

ACLI therefore believes that statutory reserves are statutory reserves. A life insurance company is subject to regulation under the insurance laws of each state in which it does business. The state insurance regulatory authorities in each state apply the NAIC guidelines in prescribing the amount of reserves that a company must report on the annual statement as the amount the insurance company has set aside to mature or liquidate policyholder or beneficiary claims arising from its insurance and annuity contracts.

Issues for Future Resolution

During the meeting, Treasury and IRS also asked for clarification regarding other issues that might need guidance during 2009, including: (1) the status of the stochastic portion of the reserve as a tax-deductible reserve, (2) the effect of the elective three-year phase-in, and (3) the potential application of the 10-year spread rules in section 807(f) to a change in the calculation of the statutory reserves. ACLI will also consider whether AG VACARVM will require updates to other Treasury or IRS guidance, and intends to continue working with Treasury and IRS to resolve further questions regarding these and other issues necessary for the issuance of guidance.

The Stochastic portion of the reserve satisfies requirements in section 807(d). As mentioned above, it is ACLI's view that both the Standard Scenario and the Stochastic excess (if any) satisfy section 807(d). ACLI recognizes that the portion of the reserve determined by stochastic modeling presents a more difficult question for Treasury and IRS and will continue to provide additional information, as needed.

If utilized, this phase-in would affect the statutory cap because the company would be holding a lower statutory reserve, and therefore could never result in an increase in the company's tax deduction.

If a life insurance company elects the three-year phase-in for AG VACARVM, it should limit that company's statutory cap. ACLI explained that, if the Guideline results in higher reserves for a company than the prior CARVM, AG VACARVM permits that company to request an elective phase-in of up to three years. ACLI expects that few companies would use this elective provision, and even if a company does apply for relief under this provision, the state insurance commissioner must approve the election and confirm that such a delay would not cause a hazardous financial condition or potential harm to the company's policyholders. If utilized, this phase-in would affect the statutory cap because the company would be holding a lower statutory reserve, and therefore could never result in an increase in the company's tax deduction.

AG VACARVM should not result in a 10-year spread under section 807(f). ACLI explained that section 807(f) concerns a change in the tax reserve method. If, for tax purposes, the tax reserve method applies the old Guidelines for contracts issued prior to 2009 and AG VACARVM for contracts issued in 2009, this would not result in a change in reserve method or basis of computing reserves under section 807.

While the statute and legislative history do not specifically address the impact of the statutory reserve limit as a change in the basis of computing reserves, the legislative history does explain that "[c]hanges in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve, but a current liability."[9] Similarly, the statutory cap is a limitation, not a reserve, so a change in the statutory cap should not be subject to the 10-year spread. ◂

End Notes

1. All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
2. Section 807(d)(3).
3. Section 801(b).
4. Section 805(a)(2).
5. Section 807(d)(1). Section 807(d)(3)(C) provides that the tax reserve cannot include deficiency reserves.
6. Section 807(d)(1) (flush language).
7. Section 807(d)(6).
8. Section 807(c)(1).
9. JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984 (Blue Book), AT 604.

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T³: *TAXING TIMES* Tidbits

Premium Deficiency Reserves Designated as Tier III Issue

by Peter H. Winslow

On Sept. 12, 2008, the Internal Revenue Service (IRS) designated the deductibility of premium deficiency reserves as its first Tier III issue specifically related to the insurance industry. According to the IRS, Tier III issues present high compliance risks within an industry. They are not mandatory for IRS audit examination, but, when raised, trigger some degree of coordination between IRS auditors and IRS industry specialists.[1] Although the IRS notice states that the issue applies to all types of insurance companies, it is really directed to property/casualty and health insurance companies.[2] SSAP 53, paragraph 15 provides as follows for premium deficiency reserves:

> When the anticipated losses, loss adjustment expenses, commissions and other acquisitions costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations.

Paragraph 16 further requires disclosure of premium deficiency reserves on the annual statement.

It is surprising that premium deficiency reserves established under the National Association of Insurance Commissioners' Statement of Statutory Accounting Principles (SSAP) 53 should be the first Tier III issue because, like their life insurance counterpart, their tax treatment is pretty clear. The regulations provide that unearned premiums do not include additional liabilities established on the annual statement to cover premium deficiencies.[3] Moreover, premium deficiency reserves generally cannot be deducted as another type of insurance reserve. In general, an insurance company is required to use an accrual method of accounting for its deductions for commissions and other policy acquisition costs and for policy maintenance costs.[4] Losses and loss adjustment expenses are deductible on a reserve basis under I.R.C. § 832(b)(5) and § 846(f)(2), but only as a fair and reasonable estimate of the amount relating to claims that already have been incurred.[5] Premium deficiency reserves are not held for incurred claims. Rev. Proc. 2002-46[6] allows an insurance company to elect to use a reserve method of accounting for certain premium acquisition expenses. For this purpose, a premium acquisition expense is defined as "an expense that is primarily related to the production of gross premiums written on an insurance contract and directly varies with the amount of gross premiums written on the underlying contract." It is possible that a portion of premium deficiency reserves may be deductible as premium acquisition expenses. But, if this special rule does not apply, it appears that there is very little controversy over the likely resolution of the IRS' first Tier III issue.

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

End Notes

1. *See* S. Mitchell, *IRS Issues Exam Guidelines to Promote Consistency, TAXING TIMES*, VOL. 3, ISSUE 3 (Sept. 2007).
2. Formulaic deficiency reserves that arise for life insurance companies when the present value of future gross premiums exceeds the present value of future net premiums are expressly excluded from life insurance reserves and total reserves by the Code and regulations. I.R.C. §§ 807(d)(3)(C), 816(h); Treas. Reg. § 1.801-4(e)(4). *See also North American Reassurance Co. v. Commissioner*, 29 B.T.A. 683 (1934).
3. Treas. Reg. § 1.832-4(a)(8)(i).
4. *Western Casualty & Surety Co. v. Commissioner*, 571 F.2d 514 (10th Cir. 1978); but see, *Ohmer Register Co. v. Commissioner*, 131 F.2d 682 (6th Cir. 1942).
5. Treas. Reg. § 1.832-4(b); see, e.g., *State of Maryland Deposit Ins. Fund Corp. v. Commissioner*, 88 T.C. 1050 (1987).
6. 2002-2 C.B. 105.

Final Regulations Issued on Information Reporting Rules for Employer-Owned Life Insurance Contracts

by Lynlee C. Baker

The Treasury Department (Treasury) and the Internal Revenue Service (IRS) have removed temporary regulations (T.D. 9364) and issued final regulations (T.D. 9431) that require taxpayers to fulfill reporting requirements under section 6039I, relating to employer-owned life insurance contracts, by filing Form 8925, Report of Employer-Owned Life Insurance Contracts. Section 6039I generally requires applicable policyholders to file a return each year showing its total number of employees, the number of employees insured with employer-owned life insurance contracts, and the total amount of insurance in force at the end of the year under these contracts, as well as other related information. Section 6039I was enacted with section 101(j) as part of the Pension Protection Act of 2006.[1] Section 101(j) generally requires businesses to treat proceeds from company-owned life insurance contracts as income, excluding as a death benefit only the premiums and other amounts it paid for the contracts, except where certain requirements are satisfied. The temporary regulations, issued late last year, merely delegated authority to the IRS to prescribe the details of the information reporting requirements for employer-owned life insurance contracts under section 6039I.[2] In connection with the temporary regulations, the IRS issued Form 8925, Report of Employer-Owned Life Insurance Contracts, to which the final regulations now refer.

Employers holding life insurance contracts should use Form 8925 to report the number of employees covered by employer-owned life insurance contracts issued after Aug. 17, 2006, and the total amount of employer-owned life insurance in force on those employees at the end of the tax year. Policyholders also must indicate whether a valid consent has been received from each covered employee, and the number of covered employees for which a valid consent has not been received for purposes of Form 8925. An insurance contract is an employer-owned life insurance contract if it (i) is owned by a person who is engaged in a trade or business that employs the insured and is the direct or indirect beneficiary of the contract, and (ii) covers the life of the owner's employee(s) on the date the life insurance contract is issued. Special rules apply in the context of master contracts. Form 8925 should be attached to the policyholder's income tax return for each tax year ending after Nov. 13, 2007, during which the policyholder has employer-owned life insurance contract(s) in force.

End Notes

1 Pub.L. No. 109-280 (2006).

2 For more detailed discussions of section 101(j) and section 6039I, *see* J. Adney and B. Keene, *New "Best Practices" Rules for Corporate-Owned Life Insurance, TAXING TIMES*, February 2007, and J. Adney and M. Garcia, *Section 101(j) and 1035-The IRS Issues Rulings Addressing Employer Owned Life Insurance, TAXING TIMES*, September 2007. *See also* L. Baker, *New Temporary and Proposed Regulations Issued on Information Reporting Rules for Employer Owned Life Insurance Contracts, TAXING TIMES*, February 2008.

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