SOCIETY OF ACTUARIES Taxation Section

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Whither the Definition of "Cash Surrender Value"—The IRS Issues More Waiver Rulings Discussing the Meaning of Section 7702(f)(2)(A)

By John T. Adney and Alison Reynolds Peak

The September 2006 issue of *TAXING TIMES* featured an article entitled "Private Rulings Regarding 'Cash Surrender Value' Under Section 7702" written by Craig R. Springfield and Brian G. King. That article discussed two private letter rulings[1] issued by the Internal Revenue Service ("IRS") in 2005 (collectively, the "2005 Rulings") that waived errors relating to the definition of "cash surrender value" under section 7702(f)(2)(A).[2] In the 2005 Rulings, the IRS concluded that certain amounts made available on the surrender of life insurance contracts, called "remittances" in the rulings, represented "cash surrender value" within the meaning of section 7702(f)(2)(A) even though they were not part of the surrender value identified as such in the contracts. In both cases, the IRS waived failures to comply with the requirements of section 7702 because the insurers' errors in interpreting the cash surrender value definition were considered reasonable under section 7702(f)(8). During 2008, the IRS issued two additional waiver rulings that reached a similar conclusion, but in doing so shed more light on the facts involved and addressed the tax treatment of the corrective action itself. The discussion that follows begins with a review of the definition of "cash surrender value" in section 7702(f)(2)(A) and in the regulations proposed under that provision but never finalized. The discussion then recaps the 2005 Rulings, describes the recently issued letter rulings, and concludes with some ruminations about the consequences of the approach being taken by the IRS.

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Actuaries
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VOLUME 5 | ISSUE 2 | MAY 2009

Taxing TIMES

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FROM THE EDITOR

By Brian King

Hello readers. The start of 2009 brought a new administration to Washington. As is generally the case, the wind of political change brings with it an increased expectation for the possibility of regulatory and legislative activity, especially in the early days. This certainly holds true with this go around. Although at the time of this writing, the anticipated activity in the insurance industry has not yet occurred, the expectation is that it will.

In the area of insurance there are many issues which could see new guidance initiatives. Among these are longevity products, VA CARVM, development of separate account DRD and health care. It will be important to understand any such guidance as it emerges. In addition—given the current financial condition of our economy—legislative changes could emerge which could affect the way life insurance companies and their products are taxed. To the extent that this type of activity does occur, it could have a profound impact on our industry.

One of the tasks of the *TAXING TIMES* editor and editorial board is to keep vigilant with regard to this expected activity and bring updates as quickly as possible to keep our readers informed. Realizing that we do have some limits given publication schedules, we will do our best to run articles in regular issues and, if necessary, in supplements to keep our readers abreast of any regulatory guidance or other changes as they emerge.

The issues listed here are some of the hot topics that we are seeing in 2009. There most likely are others; so if there are areas that you see that require a watchful eye, let me know via e-mail at *bking@smartgrp.com*. If there are topics that already exist that you feel warrant an article, please contact me with your ideas. If you are short on time or would like to team up with a colleague to coauthor an article, let me know, and we'll find you a writing partner.

Taxation Section members, this is your newsletter. We want to know what you want to hear. We want you to be part of the process—that encompasses being part of the questions as well as being part of the answers. These promise to be interesting times. There is so much going on with our country's financial condition and within our current political arena. This is not a time to sit on the sidelines. This is the time to get in the game.

Finally, you will notice that this issue of *TAXING TIMES* has a new look. In addition to some style changes, we have added a color format to our already colorful content. We hope you like what you see.

Enjoy the issue!

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

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LETTER TO THE EDITOR

Dear Mr. King,

The article, "Is Homogeneity Required to Qualify as Insurance?" by Peter H. Winslow, Susan J. Hotine and Gregory K. Oyler, appeared in Vol. 3 Issue 3 September 2007 of *TAXING TIMES*. The article states that, "The importance of homogeneity is unclear"… At the end was the "***Editor's Note:*** Can any readers shine some light on this question?"

For the last 10 years, I served as the technical advisor for Captive and Offshore Insurance Transactions (COIT). My role was to provide advice to other IRS agents on insurance issues. Having recently retired from the IRS, I would like to share my thoughts on the significance of homogeneity.

In several Revenue Rulings evaluating whether risk distribution exists, the IRS stated that the risks were homogeneous. However, I believe that was done to exclude homogeneity as a factor in those rulings. The article in the September 2007 edition of *TAXING TIMES* refers to private letter rulings (PLR) which, though not binding, may give insight into the thinking of IRS attorneys. The article criticizes PLR 200715012, but this PLR does not necessarily express the views of IRS Chief Counsel (Counsel). While normally a PLR is written by Counsel, I recognize PLR 200715012 as the Tax Exempt Agent's Examination Report.

The official position of the IRS is expressed by Counsel. Despite having received comments in response to Notice 2005-40, Counsel has not taken a position on the significance of homogeneity. (*See* ILM 200849013). Pending such guidance, revenue agents have to make their own judgment.

As the article states, risk distribution is required by the Tax Court for insurance. Homogeneity is one of the three components of risk distribution of exposures, as opposed to distribution of premiums. The function of grouping risk with similar characteristics is to increase the predictability of losses for purposes of setting unpaid loss reserves; for determining the amount to be charged as premiums and as a corollary for determining the amount of surplus needed to assume such risk. To me the grouping for loss reserves follows the grouping for setting premiums. On the questions of what risks have sufficiently similar characteristics to be grouped together, I think the IRS should follow the industry, so long as the purpose of such grouping is to increase predictability of expected losses. Homogeneity can be compared to the stratification of a population in statistical sampling. It reduces the number of exposures necessary to achieve reasonably accurate results.

Commercial carriers have adequate risk distribution for prudent business reasons. Consequently, **Homogeneity is an issue for captives and other closely held insurance companies (CHIC).** It comes up in two contexts. The first is where, for example, the Captive assumes from brother/sister corporations the risks for a fleet of automobiles and two corporate aircrafts. The argument is that both are liability insurance, but the assumption of aircraft liability does nothing to increase the predictability of the auto liability or *vice versa*. In fact predictability is decreased. A premium to surplus ratio of three to one is a rule of thumb, albeit crude. Under that formula the auto liability policy requires surplus equal to one third of the auto liability premium plus the policy limits on the two aircraft policies, since they are unpredictable. The second context in which the issue arises is when a parent needs unrelated risk in its Captive in order to be able to satisfy the risk transfer requirement for insurance between a parent and its subsidiary. The assumption of unrelated risk in a different line of business from the related risk does not increase the predictability of the risks in either line. However, if the risks in each line are reasonably predictable, we need to shift the focus from distribution of exposure units to distribution of a pool of premiums. When the Tax Court analyzed whether a deduction was allowable for parent risk transferred to its subsidiary, it focused on whether risk was

distributed among premiums from different policyholders, not on the number of exposures. When unrelated premiums are needed to pay for related losses the court held there was risk distribution and concluded that there must have been risk transfer. However, if one assumes an efficient market, then the loss cost premium on the unrelated risk line of business approaches actual unrelated risk losses, with little left over to pay for related losses. In contrast, if the unrelated risks are in the same line of business, then all such loss cost premiums are needed to pay for both related and unrelated risks. This is an area which needs further development, not from an actuarial point of view, but from a legal point of view. As the COIT technical advisor, I participated on tax panels at many captive insurance conferences. Currently, risks related to employee benefits are promoted as a source of unrelated risk for Captives. Part of my role at such conferences was to wave a cautionary yellow flag, as this issue has yet to be addressed by Counsel, or the courts.

Some argue distribution from writing multiple lines of insurance is superior to writing homogeneous risk, because the lines are not correlated. That may be true for the same reason that it is prudent to diversify a portfolio with stocks and bonds of different classes. The portfolio effect of stability of value is prudent, but it seems to me that it is a different concept from risk distribution. Risk distribution is not about stability of surplus; rather its focus is predictability of expected losses. I would argue both are valid concepts, but the portfolio effect is not risk distribution.

Risk distribution is a requirement for insurance as commonly understood. If a unique exposure is insured there is no risk distribution in terms of exposure units. However, if over half of the company's business activity is issuing policies that have risk distribution, then the company is an insurance company. The unique exposure simply increases the need for capital. In addition other forms of distribution may satisfy the fundamental principle of insurance that **the many pay for the few**. A single exposure may be assumed by bondholders in a special purpose vehicle (SPV) issuing a CAT bond. Typically such SPV would not qualify as an insurance company, because the contracts are derivative contracts as opposed to indemnity contracts. This is due to the need of bondholders for a prompt determination of loss. If the contract is an indemnity contract and thus responds only to actual losses, I think it may be accepted as insurance, so long as the risk is spread (distributed) among a substantial number of bondholders. This has been referred to as vertical distribution in contrast to the horizontal distribution of common insurance. Normally, as stated in PLR 9250021, claims are paid from premiums and investment income, the Service has yet to address the situation where the intended source of loss payment is capital instead of premium.

In conclusion, homogeneity is a CHIC issue. The IRS has not taken an authoritative position. It is my view that to achieve risk transfer from a parent to its subsidiary, the assumption of unrelated risk should be in the same line of business. The portfolio effect of multiple lines is not risk distribution.

Captives are a vehicle for formal risk retention within an affiliated group. It is not surprising that much of the controversy surrounding what is insurance, including the significance of homogeneity, flows from Captives as opposed to commercial carriers.

Sincerely,
Timothy K. Collins

FROM THE CHAIR

By Kory J. Olsen

This year seems to be flying by already. By the time this issue of *TAXING TIMES* is published, the year will be about halfway over. In puzzlement, I will be trying to decide where the year has gone and what I have done during that time. However, a more fulfilling task is to look ahead and think about what needs to be completed before the end of the year sneaks up on me (as it often does).

One item that needs to be completed before the end of 2009 is to fulfill the SOA Continuing Professional Development (CPD) requirements. This will include reviewing the requirements to see what is needed, documenting the credits for the first part of the year and planning out how to fill the rest of the credits that are needed.

The Taxation Section is a great place to start for satisfying the remaining CPD credits. This year the Taxation Section has been expanding the educational opportunities for our members. In addition to the great articles in *TAXING TIMES* and presentations at SOA seminars and meetings, we are developing new seminars and webinars.

The Section Council is developing a Tax Reserving Seminar to complement our other tax seminars (Product Tax and Company Tax). This seminar will provide details on tax reserves, what they are and how they are calculated. It is a must attend for anyone who works with reserves or is responsible for them.

It is expected that during 2009 the Taxation Section will be sponsoring both the Tax Reserving Seminar and the Company Tax Seminar. Details are being worked out, but keep on the lookout for upcoming announcements.

The Council has also added webinars to our member benefits. Webinars provide a timely and cost effective way to educate our members on current tax issues. It is a very effective supplement to the published articles in *TAXING TIMES* and in-person seminars and meetings. On March 4, 2009 we held our first webinar on the new remediation revenue procedures issued by the Internal Revenue Service (IRS) last year. It was the first of many to come.

In addition to our new offerings discussed here, we continue to cosponsor other SOA seminars and meetings. Look for the Taxation Section sessions at the Life Spring Meeting, the Health Spring Meeting, the Product Development Symposium, the Valuation Actuary Symposium and the 2009 SOA Annual Meeting.

With expanded educational opportunities, there is also an expanded opportunity to volunteer. If you are interested in helping in any way, we would like to hear from you. This could include being the section's representative on a meeting committee, presenting at a session or webcast, writing an article for *TAXING TIMES*, or helping to develop new educational opportunities. Please contact me at *kory.olsen@pacificlife.com* and let me know what you are interested in and we can steer you in the right direction.

With the year passing quickly, it is time to get involved with the Taxation Section and get your CPD credits planned out for the year. ◂

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

THE STATUTE AND THE PROPOSED REGULATIONS

Section 7702 constrains the investment orientation of life insurance contracts by requiring, in different ways, that the "cash surrender value" of a given contract have a minimum amount of death benefit associated with it. Much of the complexity of the statute arises from the legislative attempt to define what that minimum amount is. For this purpose, section 7702(f)(2)(A) provides that a contract's cash surrender value is its "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." However, nothing in section 7702 or elsewhere in the Code undertakes to define the more fundamental term, "cash value." When section 7702 was enacted in 1984, the meaning of this term was not in question. After all, nonforfeiture values available on surrender of a contract for cash had been defined in state law for over a century, and to find a contract's cash value, all that one had to do was to read the contract's terms. Just two years prior, the same, simple reference to "cash value" was used in the revision of section 72 to address the treatment of withdrawals from nonqualified deferred annuities, and there again, no elaboration of the term's meaning was provided or requested.

The legislative history of section 7702 furnished little additional guidance on the meaning of "cash value," although what it added as a gloss on the statute both spawned debate and laid the foundation for the 2005 and 2008 private letter rulings. According to the congressional committee reports on the 1984 law, cash surrender value for section 7702 purposes is "the cash value of any contract (*i.e.*, any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend."[3] Further, the committee reports' reference to "and against which the policyholder can borrow" was used in the very same legislative history to justify excluding return-of-premium benefits under credit life insurance contracts from being treated as cash values.[4] However, as the ink was drying on these reports, there apparently was some rethinking on the part of the Joint Committee on Taxation staff about what the talismanic "and" might connote. Perhaps out of some unarticulated concern, the Joint Committee staff's Blue Book on the 1984 law, published in January of 1985, modified the committee reports' statement after the fact by rephrasing it as: "and, generally, against which the policyholder can borrow."[5]

As of this writing, nearly 25 years after the enactment of section 7702, no formal regulatory guidance—whether in the form of regulations or revenue rulings—has been issued on the meaning of either "cash surrender value" or "cash value" as used in section 7702 (or section 72, for that matter). The IRS did try to issue guidance, however. In particular, when it proposed regulations in 1992 primarily to deal with the treatment of terminal illness and other life insurance accelerated death benefits, the IRS addressed those benefits in the context of a fairly elaborate structure defining "cash value" for purposes of section 7702. Under the regulations as proposed, this cash value for any life insurance contract was said to equal the greater of (1) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), "or" (2) the maximum amount that the policyholder could borrow under the contract, all subject to specified exceptions (such as death benefits, accelerated benefits for the terminally ill, and certain termination dividends).[6] Notably, the proposed definition converted the "and" in "and against which the policyholder can borrow" to a decidedly different term, *i.e.*, "or." For this and other reasons, the life insurance industry protested against the broad sweep of the proposal, and less than four years later, the enactment of sections 101(g) and 7702B rendered the principal motivation behind the proposed regulations obsolete.

However, nothing in section 7702 or elsewhere in the Code undertakes to define the more fundamental term, "cash value." When section 7702 was enacted in 1984, the meaning of this term was not in question.

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With the effort to define cash value stewing in controversy and much else to do, the IRS chose to let the proposed regulations lie fallow. Moreover, in Notice 93-37[7] the IRS announced that the effective date of the proposed regulations would be no earlier than the date of their publication as final regulations in the Federal Register. The Notice also said that it was anticipated that insurers generally would be allowed a period of time after the publication of the final regulations to bring their policy forms into compliance with any new rules. This publication has not happened, and so, as a legal construct, the proposed regulations are technically inoperative.

The death of these proposed regulations, however, has likely been exaggerated. As discussed in the previous *TAXING TIMES* article on the subject, even though the cash value definition in the proposed regulations differs materially from the definition in the legislative history, the thinking of the IRS clearly is guided by the former. At one level, this is not surprising, for it is inviting to rely on the all-encompassing and well-articulated, if broken, standard like the one proposed. At the same time, in light of the criticisms leveled against the approach taken in the proposed regulations, let alone the announcement in Notice 93-37, reliance on that standard is questionable policy. Were the IRS to proceed with revising the proposed definition of cash value, to take account of the criticisms and conform the definition to the congressional intent, and then finalizing the new rules with a prospective effective date, this would be a useful step (more on this later). At minimum, it probably would avoid the need of life insurers and the IRS to continue the saga of the letter rulings next discussed.

THE 2005 RULINGS

As described in the *TAXING TIMES* article in 2006, the contracts involved in the 2005 Rulings were fixed and variable, flexible premium contracts designed to comply with the cash value accumulation test of section 7702(a) and (b) (the "CVA Test") or, in some cases, with the guideline premium limitation and cash value corridor tests of section 7702(c) and (d) (the "GP Test"). In both rulings, the contracts provided for a policy value that was available on surrender, and also provided for certain additional amounts—labeled the "remittances" in the rulings—that would be payable on surrender in the early durations of the contracts. Significantly, the contract owners could not borrow under their contracts against these remittances, and since these amounts were not part of the policy value, the insurers involved in the rulings understandably did not reflect them in the "cash surrender value" that was used for CVA Test or GP Test purposes. Rather, only the contracts' policy value was utilized for those purposes, thereby setting up the problem that was taken to the IRS for resolution.

In the 2005 Rulings, the IRS first considered whether the remittances were properly excluded from the cash surrender value of the contracts for section 7702 purposes, and concluded that they were not. For the construction of the cash surrender value definition in section 7702(f)(2)(A), the IRS looked to a number of sources, including a leading insurance textbook that defined a contract's cash surrender value as "the amount made available contractually, to a withdrawing policyholder who is terminating his or her protection"[8] and another one that defined it as "the amount available to the policyholder upon the surrender of the life insurance contract."[9] The IRS also looked to the proposed regulations under section 7702(f)(2)(A), which (as described earlier) swept into the cash surrender value all amounts payable on surrender unless excluded by a specific exception. Applying that standard as well as the teaching of the insurance texts, the agency determined that the remittances needed to be included in the contract's cash surrender value for section 7702 purposes.

The foregoing conclusion meant, of course, that the contracts did not contain the proper formula for compliance with the requirements of section 7702. Recognizing this, the IRS next considered whether the error in not treating the remittances as part of the contracts' cash surrender value was a reasonable one within the meaning of the waiver authority granted in section 7702(f)(8). The ruling letters noted that the language of the legislative history defining the section 7702 cash surrender value was not "identical" to that of the proposed regulations—

a nod to the very different wording of the two when it came to the effect of the contract owner's borrowing rights—and that the proposed regulations had not been finalized. Citing to these facts and to the prospectivity promised in the 1993 Notice, the IRS held the error to be reasonable and used its authority under section 7702(f)(8) to waive the failures.

NEW PRIVATE LETTER RULINGS

After a brief hiatus in waiver ruling activity on this topic,[10] more of the same followed in 2008. In PLR 200841034 (March 28, 2008) (the "2008 Ruling"), the "remittances" again made an appearance as a life insurance company requested a waiver for its failure to include them in its contracts' cash surrender value for purposes of the CVA Test. This time, however, the ruling letter did not first stop to consider whether, on the merits, the remittance amount should be included in or excluded from the cash surrender value. Instead, the IRS focused on the insurer's admission of error and request for a waiver under section 7702(f)(8).

Under the facts of the 2008 Ruling, the insurer issued flexible premium, variable life insurance contracts that were designed to meet the requirements of the CVA Test "by multiplying the Contract's 'Cash Value' by a percentage identified in the Contract," this percentage being "intended to equal the amount required to maintain the Contract's compliance at all times with the CVA test." Not included in this "Cash Value," however, was an additional amount—the remittance—that the insurer guaranteed to pay if a contract were fully surrendered within its first three years. This amount, according to the ruling letter, essentially represented a portion of the premium loads assessed in the year of surrender. The ruling letter noted that the insurer had interpreted the legislative history of section 7702 as providing that the "cash surrender value" is an amount that the owner can both receive on surrender and borrow under the contract, and that as a result of this interpretation, the remittance amount, which was not subject to borrowing, was not included in the section 7702 cash surrender value under the contracts as drafted. Further, because the remittances were not part of the contract's cash value, they

did not grow with interest or earnings, nor did they decrease the net amount at risk, and hence the cost of insurance charges, under the contracts.

The 2008 Ruling then pointed out, still in the "Facts" portion of the ruling letter, that the omission of the remittances from the contract's cash surrender value resulted in the contracts' failure to comply with the CVA Test. This statement of the conclusion is quite interesting, arriving as it does after the recording of facts showing that the remittances did not function like a cash value and before any analysis in the ruling letter as to why they were, nonetheless, part of the cash surrender value under section 7702. While perhaps this approach can be justified on the grounds that the taxpayer admitted error in the first instance, it may be even more revealing of the IRS's (and the taxpayer's) view of the situation. By 2008, it was clear to the IRS and to a number of life insurers that remittance-like items were part of the section 7702 cash surrender value, whether or not they could be borrowed against, whether or not the proposed regulations had been finalized, and regardless of the terms of Notice 93-37. For that matter, such items were accepted as section 7702 cash value even though they apparently have not been so treated under state nonforfeiture law.[11] The analysis in the 2008 Ruling, for its part, generally did no more than the 2005 Rulings: after reviewing the same authorities, including the proposed regulations, noting the discrepancy in the wording on borrowing between the legislative history

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and the proposed (but never finalized) regulations, and further noting that the 1993 Notice indicated that insurers would be allowed to bring their policy forms into compliance with any new rules, the IRS concluded that the failure to satisfy the requirements of the CVA Test should be waived because the taxpayer's error was reasonable.

Then, in a departure from the 2005 Rulings, the 2008 Ruling went into greater detail about the tax treatment of the correction of the error. As in the earlier rulings, the taxpayer corrected the CVA Test compliance error by amending the contracts—in this case, adding an endorsement to the contracts—so that the remittances were included in the contracts' cash value during the period that they could be paid on surrender. This endorsement, according to the 2008 Ruling, was made effective retroactively to the issue dates of the contracts involved. Since this entailed amending the contracts, it presented a question whether the correction resulted in a material change to the contracts, raising the specter of a deemed new issue date for the contracts under the tax law. To preclude this, and presumably relying on the retroactive effective date of the endorsements, the IRS specifically held that the addition of the endorsement to correct the CVA Test failures would not affect the contracts' "issue" or "entered into" dates and did not result in a change in benefits under the section 7702(f)(7) adjustment rule or a material change for section 7702A purposes. As a result, according to the ruling, the endorsement's addition would not affect the contracts' "grandfathered" status for purposes of sections 72, 101(j), 264, 7702, and 7702A, would not affect any testing periods under sections 264(d), 7702, or 7702A, and in general would not give rise to an exchange for tax purposes. This produced a sensible conclusion, for if the correction of compliance problems itself gave rise to a material change under the tax law, the result would be a cascading of troubles for insurers endeavoring to assure that their contracts meet the requirements of section 7702.

The other recent letter ruling, PLR 200901028 (September 29, 2008) (the "2009 Ruling"), mimicked the 2008 Ruling and its forebears in large part, but elaborated on why the additional amounts were being guaranteed by the insurer. In the 2009 Ruling, a life insurance company requested a section 7702(f)(8) waiver for certain contract endorsements that caused its contracts to fail the requirements of section 7702, and further asked for material change relief similar to that requested by the insurer in the 2008 Ruling.

The statement of facts in the 2009 Ruling was similar to that of the 2008 Ruling but provided more detail. According to the ruling, the insurer issued a variety of life insurance contracts to corporate policyholders. Some of these contracts were intended to comply with the CVA Test, and the rest were subjected to the GP Test. The problem arose when the insurer endorsed the contracts involved in the ruling with an amendment that guaranteed a cash surrender value for a specified period of time that was higher than that defined in the base contracts. The ruling recorded that the insurer did so in response to requests from corporate policyholders that this guarantee of a temporarily higher surrender value was necessary to enhance the early duration policy values, so that the contracts did not have a negative effect on the policyholders' profit and loss statements during the early policy years. Further, according to the ruling, the additional surrender benefit provided by the endorsements was "a function of a return of premiums paid and/or a reduction of the charges assessed as of the date of surrender," but it "may not be borrowed against."

The insurer represented to the IRS that due to the addition of the endorsements, the contracts failed the CVA Test by the terms of the contract, and failed the GP Test if they were in the cash value corridor of section 7702(a)(2)(B) and (d) during the period when the additional benefit was available. According to the 2009 Ruling, this failure was attributable to the insurer's erroneous assumption that the amount made available on surrender was not includible in the contracts' cash surrender value for section 7702 purposes, thereby rendering the death benefits provided under the contracts improperly low. The ruling noted, interestingly, that the insurer discovered it had committed this error after reading the 2005 Rulings. This may be the best evidence yet that in the world of insurance taxa-

tion, where published guidance is difficult to come by, both insurers and the IRS look to the body of private letter rulings to divine the mysteries of the Code. As tax professionals in and out of the government recognize, however, private rulings do not constitute precedent for a reason extending beyond the formal rule in section 6110(k)(3), *i.e.*, they do not receive the thorough review that published guidance does. Query, then, whether reliance on the teachings and conclusions of private letter rulings is an appropriate way to administer the tax law, particularly when they emanate from section 7702(f)(8) waiver requests, in which the taxpayers are conceding error. (But we digress.)

In its analysis in the 2009 Ruling, the IRS reviewed the same authorities that were cited in the 2008 Ruling (and its predecessors). On the same reasoning as before, the IRS concluded that the additional cash value guaranteed on surrender for the temporary period should have been included as part of the contracts' cash surrender value for section 7702 purposes, and so it agreed that the insurer's admission of error was correct. Further, following its prior reasoning, the IRS agreed that the error was reasonable and the compliance failures therefore were waivable.

The correction discussion in the 2009 Ruling also followed the pattern of the 2008 Ruling, although with some new facts and an intriguing twist. The insurer proposed to correct its endorsed contracts either by replacing the current endorsements with new ones that complied with section 7702, or by replacing the entirety of the current contracts with new contracts and endorsements that were compliant with the statute. Further, where the new contracts or endorsements were "not in use or available"—presumably meaning not yet approved by the appropriate regulatory authorities—the insurer proposed to provide a "binding letter" to the affected policyholders promising to pay the higher death benefits resulting from the inclusion of the additional benefit as part of the cash surrender value. In connection with these steps, the insurer asked, and the IRS agreed, to hold that "[n]either the failure nor any corrective actions taken will have any effect on the dates the Contracts were issued, entered into or purchased for purposes of §§ 72, 101(j), 264, 7702 or 7702(A) [sic] and will not subject the Contracts to any retesting or restating of a new test period under §§ 264(d), 7702(f)(7)(B) or 7702A(c)." While this holding largely tracked that of the 2008 Ruling, it subtly added "the failure" as the subject of the material change relief. Why should a section 7702 compliance failure itself need such relief? Perhaps it stemmed from the fact that the contracts were endorsed in the first place, and while that endorsement gave rise to the failure, it also represented a material change. That material change would have produced potentially unwelcome consequences under at least some of the listed statutory rules. It may be that the error in the first set of endorsements provided an opportunity to rectify that situation.

CONCLUDING COMMENTS

The 2008 Ruling and 2009 Ruling were in large part a repetition of the 2005 Rulings, and hence were consistent with the IRS's prior ruling position. While the new rulings show that the IRS continues to adhere to its view that the "remittances" and like additions to a contract's formal cash surrender value are properly considered part of the section 7702(f)(2)(A) cash surrender value, they also show that the agency treats the regulatory requirement in this respect—basically the regulations that have remained in proposed form for over 16 years—as unclear to taxpayers, thus warranting the waiver of the resulting compliance failures. The new waiver rulings, coupled with the 2005 Rulings, further suggest that life insurance companies are taking a conservative approach on this subject, being willing to view the amounts in question as part of the section 7702 cash surrender value even in the absence of published guidance requiring it.

Why should a section 7702 compliance failure itself need such relief? Perhaps it stemmed from the fact that the contracts were endorsed in the first place, and while that endorsement gave rise to the failure, it also represented a material change.

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The body of waiver rulings discussed here hint at, but do not directly address, a potentially much more significant subject: the return-of-premium benefits provided under many life insurance contracts today, including term life insurance contracts that do not provide for cash surrender values at all. The 2009 Ruling appears to come closer to this subject than do the others in saying, as quoted above, that the additional surrender benefit with which it was concerned was in part "a function of a return of premiums paid." It may well be tempting to jump from the conclusions of the waiver rulings, and from the all-encompassing formula of the proposed regulations, to judge all return-of-premium benefits to be cash surrender values, or parts of other cash surrender values, within the meaning of section 7702(f)(2)(A). Sound discretion, however, should dictate a more careful consideration of the matter. As a procedural matter, the waiver rulings, being private letter rulings, are not precedential, and the proposed regulations are not effective, as witnessed by Notice 93-37. On the merits, those proposed regulations are all too all-encompassing, extending the cash value definition well beyond the thinking of Congress, which the courts would say should be construed to reflect what cash value, as a term of art, was understood to mean under state insurance law *circa* 1984. When Congress has considered benefits that merely return premiums paid, it has not viewed them in the same manner as insurance or annuity cash values that possess a savings element, and hence it has (as noted above) excluded such benefits provided under credit life insurance from cash surrender value treatment under section 7702, and also it has permitted such benefits under "qualified" long-term care insurance contracts (under section 7702B) while generally banning cash surrender values from those contracts. Hence, while treating return-of-premium benefits as cash surrender values may be appealing to the IRS, the transit from disregarding those benefits to fully recognizing them under section 7702(f)(2)(A) is not a simple matter, or a trip that should be taken lightly.[12]

What, then, is the magic solution? A new regulatory project may be the simplest, most straightforward way to put to rest all of the outstanding questions. This could involve the issuance of a new notice of proposed rulemaking that updates, revises, and narrows the cash surrender value definition put forth in the 1992 proposed regulations. If this were done, accompanied by the required invitation for comment and by appropriate transition provisions, it would represent a significant step forward in enabling compliance with section 7702. ◂

END NOTES

1 PLR 200521009 (February 22, 2005); PLR 200528018 (April 12, 2005).

2 All references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

3 S. PRT. No. 98-169, vol. I, at 573 (1984); H.R. REP. NO. 98-432, pt. 2, at 1444 (1984).

4 *Id.*; STAFF OF J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 648 (Comm. Print 1984) ("1984 Blue Book").

5 1984 Blue Book at 647.

6 Prop. Treas. Reg. § 1.7702-2(b)(1).

7 1993-2 C.B. 331.

8 KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE & HEALTH INSURANCE 46 (13th ed. 2000).

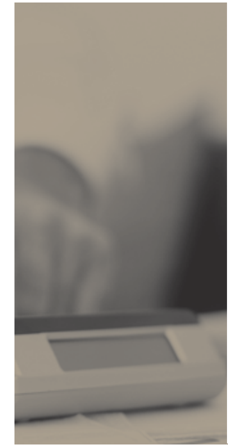
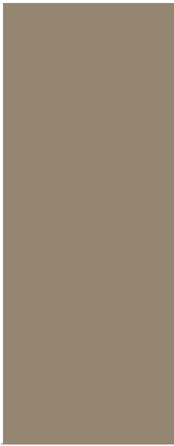
9 JOHN H. MAGEE, LIFE INSURANCE 599 (3d ed. 1958).

10 There was another private letter ruling addressing the section 7702(f)(2)(A) cash surrender value definition during the interim, but it was not a waiver ruling. That ruling, PLR 200745006 (August 9, 2007), involved a request for an affirmative ruling on the application of that definition, although the redacted version of the ruling released to the public does not disclose much information about the precise nature of the ruling requested or about the insurance product involved. Based on what can be gleaned from the non-redacted portions of the letter ruling, some amount greater than the "policy value" of the base contract would be payable on surrender if the contract was issued with a particular rider. Consistently with its ruling policy on the waiver rulings discussed herein, and citing to the same authorities and rationale as in the waiver rulings, the IRS held that the greater amount payable on surrender needed to be recognized as the cash surrender value for section 7702 purposes.

11 Interestingly, at times the IRS has been of two minds on the seeming breadth of the cash value definition. The amount a life insurer's deduction for the increase in its reserve for a contract under section 807 is dependent in part on the contract's "net surrender value," which section 807(e)(1)(A) defines as essentially the contract's cash value determined without regard to surrender charges. In audits of life insurers' taxes, the IRS has contended that a contract's net surrender value was less than its full nonforfeiture value, even after reduction for surrender charges, at least where all of that nonforfeiture value could not be realized during the taxable year at issue.

12 *See also* National Association of Insurance Commissioners, "Actuarial Guideline CCC – The Application of the Standard Nonforfeiture Law for Life Insurance to Certain Policies Having Intermediate Cash Benefits," relating to *inter alia* the treatment of return of premium benefits under state nonforfeiture law. This guideline, adopted last year, is applicable "for all policy forms filed on or after January 1, 2009, and affects contracts issued on or after January 1, 2010."

INSURANCE TRANSFER PRICING: ISSUES FOR LIFE REINSURANCE TRANSACTIONS

By Christian DesRochers

Offshore reinsurance, particularly with affiliated reinsurers, is seen by tax authorities as creating the potential for tax avoidance. While this has historically been more in the context of property and casualty insurance, the increased number of transactions dealing with term insurance and secondary guarantee universal life under National Association of Insurance Commissioners (NAIC) regulations XXX and AXXX has increased the visibility of transfer pricing issues for life insurers.[1] In addition, FIN 48 has increased the awareness of the need to document and substantiate transfer pricing practices to tax authorities.[2] This article will describe the transfer pricing rules applicable to life reinsurance transactions generally, and then will outline a methodology for testing life reinsurance transactions to demonstrate compliance with transfer pricing standards applied by tax authorities.

TRANSFER PRICING DEFINED

When independent enterprises deal with each other, the conditions of their commercial and financial relationships (*e.g.*, the price of goods transferred) are governed by market forces. When associated enterprises deal with each other, their relationships may not be determined by market forces in the same way, but may be influenced by management or tax considerations. A transfer price is the price at which goods and services, financing, or intellectual property are transferred between related parties. That is, a transfer price is the monetary expression of a movement of goods or services between organizations of the same enterprise. Multinational enterprises ("MNEs") use transfer prices for the sale of goods and services within the corporate group. Transfer prices can be used to move profits, and taxes, between jurisdictions. From a tax perspective, transfer prices can be a significant element in determining the MNE's distribution of taxable income among the various tax jurisdictions in which it operates. As a consequence, it is therefore not surprising that tax authorities are concerned that the correct profit is attributed to economic activity in their jurisdiction, in order to collect the appropriate amount of tax attributable to the activity. Transfer pricing rules are intended to ensure the proper allocation of revenue between jurisdictions in which the entities are taxed.

In recent years, a firm's transfer pricing policy has emerged as a significant element of tax risk management. In their *2007-2008 Global Transfer Pricing Survey*, Ernst & Young commented:

> Tax departments are under increasing pressure to manage transfer pricing risks with greater precision, yet a rapidly developing regulatory environment, new enforcement tactics, and shifting fiscal policies make this even more complex to achieve. The degree of transparency in MNE's tax and transfer pricing provisions, largely driven by developments in financial and tax disclosure requirements, has dramatically increased in recent years.[3]

Further complicating the picture is the global trend toward international tax authority collaboration and information exchange. This increased scrutiny leads to increased compliance costs.

OECD TRANSFER PRICING STANDARDS

The international framework for economic analysis is set forth by the Organization for Economic Co-operation and Development ("OECD") in its 1995 publication *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("OECD Guidelines"). The OECD endorses the arm's length principle as the basic rule governing the tax treatment of non-arm's length cross-border transactions. The arm's length principle is articulated in Article 9 of the OECD Model Tax Convention. This principle requires that, for tax purposes, taxpayers conduct their transactions with non-arm's length parties on the same terms and conditions that would have prevailed if the parties had been dealing at arm's length. That is, the arm's length transfer price should be comparable to the price for similar transactions between independent entities. The application of this principle ensures that a taxpayer that is a member of a multinational group and that engages in transactions with members of the group pays substantially the same amount of tax as it would have paid had the members of the group been dealing with each other at arm's

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length. The determination of whether a taxpayer has adhered to the arm's length principle is a question of fact.

Paragraph 1.13 of the OECD Guidelines notes: "The arm's length principle is sound in theory since it provides the closest approximation to the open market in cases where goods and services are transferred between associated enterprises." Paragraph 1.15 of the OECD Guidelines states that the application of the arm's length principle is generally based on a comparison of the prices or margins used or obtained by non-arm's length parties with those used or obtained by arm's length parties engaged in the same or similar transactions. In order for the price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be identical or at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in the characteristics of the transactions. The problem with the "arm's length" standard is that it only works well when comparable market prices are available. In some cases it may be possible to apply the arm's length principle to arrive at a single transfer price or margin which is used to determine whether a transaction is conducted at arm's length. However, this is generally not the case. Paragraph 1.45 comments that: "because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable."

The principal method put forward by the OECD is the Comparative Uncontrolled Price Method ("CUP"), which looks toward the sale of the same or similar products to unrelated persons. An uncontrolled price is the price agreed upon between unconnected parties for the transfer of goods or services. If this transfer is in all material respects comparable to transfers between associates, then that price becomes a comparable uncontrolled price. The CUP compares the price charged for a property or service transferred in a controlled transaction with the comparable price in an uncontrolled transaction. There are two possible sources of a CUP. First, the taxpayer may sell the particular product in the same quantities, under the same terms and in the same markets to parties with whom it deals at arm's length (an internal comparable). Second, other taxpayers may sell the same product, in the same quantities, under the same terms and in the same markets, to arm's length parties (an exact comparable uncontrolled price). Where the information is readily available, the CUP method is the most direct and accurate method of checking transfer prices. As a result, the CUP method is preferred by OECD and most tax authorities.

The OECD Guidelines also outline other methods, which are characterized as traditional (transaction-based) or non-traditional (profit-based).[4] In terms of the traditional methods outlined by the OECD, the comparable uncontrolled price method, if applicable, will provide a higher degree of comparability than any of the other methods. Under the OECD Guidelines, the transactional profit methods may be used "in those exceptional circumstances in which the complexities of real life business put practical difficulties in the way of the application of traditional transaction methods."[5] While the ordering of the recommended methods is clear in theory, the lack of reliable information necessary to apply a particular method may require the application of a lower-ranking recommended method for which adequate information is available.

SECTION 482 TRANSFER PRICING RULES

The transfer pricing tax rules in the United States are set forth in Section 482 of the Internal Revenue Code and the related regulations.[6] Section 482 provides that "the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." Thus, the standard to be applied by a MNE with respect to the United States is that the transaction as it is reported on a tax return "clearly reflects income." In 1968, the Treasury Department ("Treasury") published regulations that follow the "arm's length" standard.[7] Treasury Regulations 1.482-1(b)(1) provide that "the standard to be applied in every case is that of a

taxpayer dealing at arm's length with an uncontrolled taxpayer." Put differently, the arm's length standard is met if the results of a transaction are consistent with the results that would have been realized if unrelated taxpayers had engaged in a comparable transaction under comparable circumstances.[8]

In principle, the U.S. rules are very similar to the OECD Guidelines; however, a significant way in which the section 482 rules diverge from the OECD standards is in the choice of method. While the OECD rules imply a hierarchy, with the CUP method preferred, the arm's length result of a controlled transaction under section 482 must be determined under the "best method" rule. Regulations 1.482-1(c)(1) define this as the "method that, under the facts and circumstances, provides the most reliable measure of an arm's length result." Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. The Regulations also provide that "data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length."[9] In determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are: (1) the degree of comparability between the controlled transaction (or taxpayer); and (2) any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. While not following the OECD characterization of the profit-based measures as a "last resort," the Regulations also note that "an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods."[10] At the same time, although the OECD rules generally favor transaction-based methods, the approach in the United States appears to be more heavily weighted toward profits-based methods.

SECTION 845(a) REINSURANCE RULES

Section 845 was enacted in 1984 and provides the Treasury the authority to reallocate items in a reinsurance arrangement to prevent the use of reinsurance as a tax avoidance device.[11] Section 845(a), dealing with related party transactions, was amended in 2004 to clarify that the Treasury Department had authority to allocate among the parties to a reinsurance agreement or to recharacterize income (or to make any other adjustment in order to reflect the proper source, character, or amount of the item.)[12] In clarifying that this authority included the amount (not just the source and character) of any such item, Congress expressed the concern that "reinsurance transactions were being used to allocate income, deductions, or other items inappropriately among U.S. and foreign related persons," and that "foreign related party reinsurance arrangements may be a technique for eroding the U.S. tax base."[13]

As amended, section 845(a) provides that the Secretary may—

(1) allocate between or among such persons income (whether investment income, premium, or otherwise), deductions, assets, reserves, credits, and other items related to such agreement,
(2) recharacterize any such items, or
(3) make any other adjustment,

if he determines that such allocation, recharacterization, or adjustment is necessary to reflect the proper amount, source, or character of the taxable income (or any item described in paragraph (1) relating to such taxable income) of each such person.

> In principle, the U.S. rules are very similar to the OECD Guidelines; however, a significant way in which the section 482 rules diverge from the OECD standards is in the choice of method.

There is clear overlap between sections 845 and 482, as the "clear reflection of income" standard underlies both sections.

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The Internal Revenue Service ("IRS") is free to apply either or both sections with respect to reinsurance transactions. However, the transfer pricing penalties, as well as the broad application of the transfer pricing standards, may push the analysis to follow transfer pricing rather than the specific reinsurance-related provisions of section 845(a). In addition, the regulations under section 482 provide both taxpayers and the IRS with standards for determining if a transaction is in compliance with the arm's length standard, while regulations have not yet been issued under section 845.

TRANSFER PRICING FOR REINSURANCE TRANSACTIONS

A reinsurance contract is an agreement between an insurer (the ceding company or cedant) and a reinsurer. The insurer writes the underlying policy and is contractually responsible for any payments to the policyholders that come due under the policy, even if those insured risks are ultimately met by a reinsurer as part of a reinsurance contract. The insurer markets the policy, bears the costs of its sale and ongoing administration, and receives the premium income associated with the policy.[14] Under a typical coinsurance agreement involving inforce insurance, the initial reinsurance premium is equal to the reserve and the reinsurer pays the ceding company an allowance, called a ceding commission. The transaction is usually conducted on a net basis, with the ceding company transferring assets to the reinsurer that have a market value equal to the reinsurance premium less the ceding commission. Generally, the result is a net payment made by the cedant to the reinsurer. However, reinsurance contracts may, in certain market conditions, create a loss where ceding commission paid by the reinsurer does not cover the insurer's costs or where a negative ceding commission is paid to the reinsurer. In evaluating a reinsurance transaction under the transfer pricing rules, the two key questions would appear to be:

1. Can it be demonstrated that the ceding commission has been calculated on an arm's length basis?
2. Would the cedant have undertaken the transaction had it been with an independent reinsurer?

As previously noted, Section 482 requires that a taxpayer evaluate an intercompany transaction by applying the method that produces the most reliable measure of an arm's length transaction. In selecting the "best method," the Regulations note that the taxpayer must consider the following:

1. The availability of data to serve as an arm's length benchmark.
2. The reliability and completeness of the data that is available.
3. The quality of the assumptions required in order to apply the data.
4. The number and type of adjustments that need to be applied to the data to improve comparability.

The quality of the data and assumptions are important criteria in selecting the best method. The burden is on the taxpayer to show that the results under the method selected produces the most reliable result. In practice, there are a number of approaches that can be used to evaluate inter-group reinsurance transactions. However, all of these are based to some degree on an actuarial pricing approach, but have been character-

ized in different ways based on the way in which the analysis was presented. The methods include a direct or indirect CUP and the comparable profits method ("CPM"), known as the transaction net margin method ("TNMM") under the OECD Guidelines. The section 482 regulations also provide for so-called "unspecified methods," using as an arm's length result the price that would have been realized in an independent alternative to the controlled transaction. Perhaps the most accurate characterization of an actuarial method is an unspecified method under section 1.482-3(e) of the Regulations.

Determination of the Comparable Uncontrolled Price

The CUP method for tangible property (and the related Comparable Uncontrolled Transaction Method ("CUT") for intangible property) evaluates whether the price charged in a controlled transaction is arm's length by reference to the amount charged in a similar uncontrolled transaction under the same circumstances.[15] That is, under the CUP approach it is necessary to establish if a comparable transaction exists in the marketplace between unrelated parties. Clearly, the CUP method works best in circumstances where an affiliated company operates in a competitive market where comparable prices are readily observable. If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of Regulations 1.482-1(d)(2). As discussed below, the CUP can be very difficult if not impossible to apply in practice to reinsurance because of the lack of truly comparable transactions, as there is no actively traded market for insurance liabilities.

Reinsurance pricing follows the same principles as traditional insurance pricing, as the reinsurance actuary must evaluate the plan in terms of the anticipated experience of the ceding company. Further, an actuarial appraisal value or other projection of the future cash flows or distributable earnings of a block of business will produce a unique value based on the product and risk characteristics of the policies making up the block of business. It is therefore impossible to treat reinsurance as a commodity, for which a standard price can be set, or for which a benchmark market price can be calculated. A common statement made in support of the arm's length nature of inter-company reinsurance transactions is that "inter-company transactions are priced on exactly the same basis as for external reinsurance."[16] To use this to establish the validity of a transaction under the CUP, there should be a sufficient record to support that such a policy exists and internal controls to ensure the implementation of the policy. One possible advantage of this approach is that, to the extent that it can be shown that the same pricing models and methodologies are applied for both internal and external reinsurance pricing, multiple transactions might be supported and documented on this basis. Establishment of a CUP for reinsurance may also be possible if the insurer has purchased the same reinsurance coverage externally in the recent past or a third-party reinsurer shares the same terms as the related reinsurer, as a co-reinsurer or retrocessionaire. If the ceding company reinsures comparable business in the open market, then it may be appropriate to use the ceding company's reinsurance pricing model to establish a comparable price as an indirect CUP.

> A common statement made in support of the arm's length nature of inter-company reinsurance transactions is that "inter-company transactions are priced on exactly the same basis as for external reinsurance."[16]

Alternatively, a modified or indirect CUP approach to generate an arm's length price for a reinsurance transaction looks to the price at which an insurer would be prepared to assume the liabilities being ceded, if this business were offered by a third-party external insurer. It may be possible, by the use of an actuarial pricing model, to demonstrate that the pricing of the related-party business is similar to the pricing of the external business. This may require that the insurer have a presence in the reinsurance market to justify the pricing of third-party transactions. Regulations

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1.482-3 (b)(5)(i) note that indirect evidence of a comparable uncontrolled price may be derived from data from public exchanges or quotation media, but only if the data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales; and the data derived from public exchanges or quotation media is used to set prices in the controlled transaction.

A more direct approach is to simply characterize the actuarial method as an "unspecified method."[17] Regulations 1.482–4(e) provide an "unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it." This would allow the appraisal methodology to be applied on its merits, without trying to characterize it as a direct or indirect CUP. An actuarial appraisal methodology (the approach ordinarily employed to assess the overall financial soundness of a U.S. insurer) is an appropriate measure of an uncontrolled price to determine whether reinsurance transactions between affiliates are conducted on an arm's length basis.[18] An alternative to a specific reinsurance model would be to develop data and assumptions from the Actuarial Opinion and Memorandum filed with state regulatory authorities relative to the policies being reinsured.[19]

Determination of the Comparable Profit

The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.[20] The comparable profits method is applied by first developing a sample of financial data, or profit level indicators ("PLI"), from companies that are seen as similar to the tested company. These are applied to the determination of an arm's length result by comparing the operating profits that result from related party transactions with the profits of an uncontrolled comparable (comparable operating profit) based on the profit level indicator. Comparable operating profit is calculated by "determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity)."[21]

Comparability under the CPM is dependent on the similarity of invested capital and risks assumed under comparable affiliate and non-affiliate transactions. However, the CPM requires that the simpler entity in the transaction be the "tested" party to be evaluated. The analysis under the CPM is based on PLIs, including the rate of return on capital employed, or financial ratios which measure relationships between profit and costs or sales revenue.[22] In practice, the CPM could be applied to a reinsurance transaction by comparing the return under the reinsurance agreement with the return on equity or the return on assets of comparable insurance or reinsurance companies over comparable periods of time.

Development of Transfer Pricing Documentation

In analyzing a reinsurance transaction, one approach to developing transfer pricing documentation to determine whether the pricing of a reinsurance transaction has been arm's length based on an actuarial appraisal methodology (as an unspecified method) supported by a CPM analysis using published financial data of comparable companies. The analysis would consist of the following broad activities:

1. Review the factual information regarding the acquisition including the reinsurance agreement and any actuarial appraisals that may have been made in connection with the transaction.
2. Validate the actuarial appraisal method as the "best" method under section 482.
3. Generate an actuarially determined range of values for the ceding commission based on the data and assumptions in the actuarial appraisal or the most recent AOMR that covers the business under the agreement.

4. Compare the ceding commission to the arm's length actuarially determined values.
5. Determine the comparable companies for the CPM validation.
6. Identify and compute the relevant PLIs for the CPM analysis and compare to the transaction-generated values.

In doing the analysis described here, it may not be possible to calculate in advance the precise price at which a reinsurance transaction will be concluded. However, the economic value is the underlying basis for the price paid, where value is defined as the economic value or range of economic values derived using an actuarial appraisal. As with any actuarial exercise, the setting of the assumptions is one of the most difficult tasks of an actuarial appraisal, requiring considerable judgment and expertise.

CONCLUSION

Insurance companies, particularly life insurers, have traditionally not seen transfer pricing as a major area of concern. Tax issues related to reinsurance have dealt more with the presence or absence of risk, and not the price at which the transaction takes place. However, that view is changing in the face of the increasing globalization of the life insurance industry. From the perspective of the tax authorities, the transfer pricing calculation determines the profits of a business that are subject to tax in a given jurisdiction. Increasingly authorities in the United States and overseas are scrutinizing transactions to assure that the arm's length standard is met. This is particularly the case where large amounts of business are ceded, the ceded business is highly profitable, or the nature of the risk is such that similar transactions from which to develop comparables are not likely to be readily available. Transfer pricing documentation of affiliated reinsurance is an exercise that can involve actuaries, accountants, and attorneys. However, it is an art not a science, and there are significant penalties that can be imposed for the failure to follow and document the arm's length nature of a reinsurance agreement. ◀

END NOTES

[1] For at least a decade, the reserve standards articulated in *The Valuation of Life Insurance Policies Model Regulation* (commonly referred to as Regulation XXX or National Association of Insurance Commissioners (NAIC) Model Regulation 830) and more recently, Actuarial Guideline 38, *The Application of the Valuation of Life Insurance Policies Model Regulation* (commonly referred to as AXXX) have been the subject of controversy within the life insurance industry.

[2] FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes.*

[3] *Precision under pressure – global transfer pricing survey 2007-2008,* Ernst & Young, 4.

[4] There are 5 transfer pricing methods described in the OECD Transfer Pricing Guidelines. These are characterized as transaction-based and profit-based methods. The traditional methods (transaction-based) are: 1. Comparable uncontrolled price method; 2. Cost-plus method; and 3. Resale price method. The non-traditional methods (profit-based) are: 1. Profit split method; and 2. Transactional net margin method. The profit-based methods are based on comparisons of profit rates or margins as a means to estimate the profits that one or both members of an associated enterprise could have earned had they dealt solely with independent enterprises. Methods based on profits are acceptable only to the extent that they are compatible with Article 9 of the OECD Treaty. This is achieved by applying the methods in a manner that approximates arm's length pricing. That is, the profits from controlled transactions are compared to profits arising from comparable transactions between unrelated parties.

[5] The OECD approved the profit split method and the transactional net margin method as "methods of last resort" in 1995. Since that time, however, there has been increasing pressure on the OECD to give broader recognition to the profit-based methods given their wide application.

[6] IRC section 1060 applies to reinsurance transactions where the purchaser acquires significant business assets in addition to the insurance contracts. In that case, the regulations under section 338 may override the usual section 482 regulations for reinsurance. *See* Mark H. Kovey and Lori J. Jones, "Highlights of the Recent Guidance on Insurance Company Acquisitions," *TAXING TIMES,* September 2006.

[7] The regulations were modified in 1994 to add profit-based measures.

[8] However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

[9] Regulations 1.482-1(c)(2).

[10] Regulations 1.482-1(c)(2)(i).

[11] Conference Report to H.R. 4170, The Deficit Reduction Act of 1984, H. Rep. No. 98-861 (June 23, 1984), 1060. Section 845(a) deals with affiliates, while section 845(b) deals with non-related party reinsurance. *See Trans City Life Insurance Company v. Comm'r*, 106 T.C. 274 (1996), non-acq., 1997-2 C.B. 1, Nov. 3, 1997 for a discussion of issues related to non-affiliated reinsurance under section 845(b).

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END NOTES (CONTINUED)

[12] Section 803 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[13] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05, May 2005, 351.

[14] Although some reinsurance transactions may also include a transfer of administration of the policies to the reinsurer.

[15] In July 2006, the Treasury issued Temporary Regulations related to intra-group services. The regulations identified a "black list," which included insurance and reinsurance, of types of services that could not be charged at cost.

[16] *Transfer Pricing Key Issues: Reinsurance: a transfer pricing 'hot topic,'* Financial Services Transfer Pricing Perspectives, PricewaterhouseCoopers LLP, February 2008, 9.

[17] Regulations 1.482-4(d)(1). Regulations 1.482-4(d)(2) appears relevant to reinsurance as it provides an example which relates an arm's length price to the profit a related party would have earned if it carried out the transaction itself rather than licensing it to a subsidiary.

[18] Actuarial Standard of Practice No. 19 (ASOP 19), *Appraisals of Casualty, Health, And Life Insurance Businesses*, is effective for all appraisals of casualty, health, and life insurance businesses initiated on or after November 1, 2005. For insurance transactions, the generally accepted method of analysis is an actuarial appraisal. Actuaries perform appraisals for a number of purposes and for a variety of users, including sellers, buyers, management, and regulators. Actuaries perform appraisals of insurance businesses of various types using a variety of methods. In some cases, appraisals performed by actuaries show values that are discounted present values of earnings, distributable earnings, or other amounts. An actuarial appraisal is a specific type of appraisal. The key distinguishing feature of an actuarial appraisal is the projection of the future stream of distributable earnings attributable to the evaluated business based on the applicable regulatory accounting basis. This stream of earnings includes the runoff of claim liabilities and other liabilities carried on the balance sheet at the valuation date as projected using actuarial assumptions relating to items such as mortality, persistency, expenses, and investment return. The projections may be done for existing and new business separately or in combination. The projected earnings are then discounted at the selected discount rate(s) to derive the actuarial appraisal value.

[19] NAIC Model Regulation 822, entitled *Actuarial Opinion and Memorandum Regulation* requires all life insurance companies and fraternal benefit societies to submit actuarial opinions based on an asset adequacy analysis.

[20] As described in the OECD Guidelines, the TNMM compares the net profit margin of a taxpayer arising from a non-arm's length transaction with the net profit margins realized by arm's length parties from similar transactions. A net margin method uses margins computed after operating expenses. An issue that arises with the TNMM is that the method is typically applied to only one of the associated enterprises. While the resale price and cost-plus methods are also one-sided, the fact that there are many factors that enter into the calculation of the net margin may implicitly leave other members of the group with unusually high (or low) profit levels. As a result, Paragraph 3.45 of the OECD Guidelines indicates it is "important to take into account a range of results when using the transactional net margin method."

[21] Regulations 1.482-5.

[22] The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this profit level indicator increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable.

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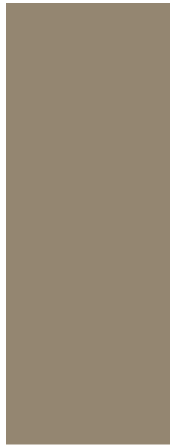
SO, WHAT ABOUT HSAs?

By Randall J. Wichinski and Charla Jo Finley



The economic crisis has certainly captured the attention of the media and, for that matter, everyone else as homes and jobs continue to be lost. With the new year in full swing, and a new administration in the White House, it will be interesting to see what actions are taken by President Obama and Congress for economic recovery toward financial stability. In addition, the details regarding President Obama's health care plan and universal coverage have not yet been revealed, so the future of individual health care coverage is currently unclear.

Employers have also taken action to maintain profitability or to stem financial losses. Many employers have cut both jobs and benefits, particularly health benefits. In recent years, employers have gradually increased the amount of health premiums required to be paid by employees, and the health plans being offered by employers are now providing streamlined coverage, with significantly higher deductibles and copayments. Unfortunately, the high deductible coverage offered by most employers is not provided through qualified "high deductible health plans" ("HDHPs") that would allow an employee to open a health savings account ("HSA"). As a result, only 2 percent of the individuals with private health insurance in 2006 were covered by HSA-eligible plans; which is much less than HSA advocates had envisioned.

SO, WHAT ABOUT HSAs, AND WHAT ARE THEY?

According to the U.S. Treasury—HSA Web site, "A Health Savings Account is an alternative to traditional health insurance; it is a savings product that offers a different way for consumers to pay for their health care. HSAs enable you to pay for current health expenses and save for future qualified medical and retiree health expenses on a tax-free basis."

The funds contributed to an HSA are not subject to federal income tax at the time of deposit. Although an HSA might appear to be similar to a flexible spending account ("FSA"), the funds contributed to an HSA are owned and controlled by the individual, not an employer, and they can accumulate tax free year after year. HSA participants can withdraw their funds at any time and for any reason, without approval from their employer, the insurance company or the HSA trustee. If withdrawn funds are used for something other than qualified medical expenses, the amount of such funds is subject to income tax *and* a 10 percent penalty; however, if the HSA participant has reached the age of 65 or is disabled at the time of the withdrawal, the 10 percent penalty is waived.

Internal Revenue Code ("IRC") §223, entitled "Health Savings Accounts," was created by Public Law 108-173, the "Medicare Prescription Drug, Improvement and Modernization Act of 2003," which was signed into law by President Bush on Dec. 8, 2003. Since their inception, HSAs have been viewed as a way for millions of individuals to meet their current and future health care needs because they are designed to help save for qualified medical and retiree health expenses on a tax-advantaged basis.

In general—and from a practical standpoint—HSAs offer a great way for individuals to pay for qualified medical expenses with pre-tax income both before and during retirement. Currently, HSAs are far more tax favored than any other health or retirement account. Contributions from an employee or an employer may be made on a pre-tax basis, and individual contributions to an HSA are tax deductible. The investment income earned on an HSA is earned on a tax-deferred basis. Withdrawals from an HSA are not subject to income tax if made for qualified medical expenses, including dental and vision care. Finally, when a person dies, any remaining funds in the HSA can be transferred tax free to a surviving spouse. In effect, HSAs provide a triple tax advantage—deductible, deferred and tax-free withdrawals (with some restrictions).

HOW DO I QUALIFY FOR AN HSA?

To be an eligible individual and qualify for an HSA, you must be covered under an HDHP on the first day of the month. In addition, you cannot have any other health coverage, except for certain types of permitted coverage; and, you cannot be enrolled in Medicare. Finally, you cannot be claimed as a dependent on someone else's federal income tax return.

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A qualifying HDHP has a higher annual deductible than other health plans, and as a result, such plans typically charge a premium that is approximately 50 percent less than certain other types of coverage. Unlike some HDHPs, a qualifying HDHP must have a maximum limit on the sum of the annual deductible and the out-of-pocket medical expenses, which includes copayments and other amounts but not premiums. The minimum and maximum annual deductibles and the other out-of-pocket amounts are adjusted for inflation and determined annually. Finally, although the HDHP may provide preventive care benefits without a deductible, such care is limited to certain specific types of benefits.

Although many people incorrectly believe that qualifying HDHPs, by definition, do not provide first-dollar coverage, a July 2007 industry survey conducted by the America's Health Insurance Plans ("AHIP") found that "84% of the HDHPs purchased in the group and individual markets provide first-dollar coverage for preventive care." This was true for 99 percent of the policies in the large-group market, 95 percent of small-group plans, and 59 percent of plans purchased by individuals.

For an individual or a family that has coverage from only one health plan, the HSA and HDHP rules discussed here are relatively straightforward. First, your health plan must qualify as an HDHP. For 2009, this means a self-only plan must have a deductible of at least $1,150 and a maximum out-of-pocket amount of $5,800. For a family plan, which includes the typical family plan as well as employee and spouse, and self-plus-one, the amounts are $2,300 and $11,600, respectively. Keep in mind that the deductible must apply to all medical expenses before any insurance coverage or employer reimbursement is received. If your plan is an HDHP you may contribute up to $3,000 to a HSA for self-only coverage and $5,950 for family coverage. For individuals age 55 and older, an additional $1,000 annual "catch-up" contribution can also be made.

WHAT ABOUT SPOUSAL COVERAGE?

If you and your spouse have health coverage under more than one plan, the rules get more involved and you need to closely examine your coverage. Your employer likely will not know about your other coverage and may be of little help in determining what you should do. Unfortunately, under certain circumstances, a well-intentioned HSA contribution from your employer could potentially result in an excess contribution and a 6 percent excise tax unless the amount of the excess contribution from your employer is included as additional compensation on your Form W-2.

The first thing you must do is examine the health insurance policies under which you receive coverage. Do any of them not meet the HDHP requirements? If so, you are not eligible to make contributions to an HSA. For example, if you have self-only coverage under an HDHP plan through your employer, but you are also covered by your spouse's first-dollar coverage plan, you are not eligible to contribute to an HSA.

Once you have determined that both you and your spouse are HSA-eligible individuals, the amount you each may contribute to an HSA depends on the type of plans you have. If you both have self-only coverage, you can each contribute up to $3,000 into your own HSA. If at least one of you has family coverage, then your total combined contributions are limited to the family coverage limit of $5,950. The amount each spouse contributes to a separate, individual HSA can be determined by agreement. If only one spouse is an eligible individual then that spouse may contribute to an HSA based on the type of coverage they have, either self-only or family.

WHAT HAPPENS IF I LOSE MY JOB?

Currently, many employees are finding themselves in the unfortunate situation of having lost their job. In certain situations, health coverage may continue to be provided by their employer for a short period of time. The Consolidated Omnibus Budget Reconciliation Act of 1985, better known as COBRA, generally requires employers, with a group health plan for 20 or more employees, to provide former employees and dependents with the opportunity to continue group health coverage for a limited period of time. Many rules apply to COBRA benefits; however, in general, the continuation coverage must be the same and the "applicable premium," which

is typically paid in full by the employee, is equal to or slightly more than the cost to the plan of providing coverage.

It is permissible for a terminated employee to pay the "applicable premium" for COBRA coverage with funds withdrawn from an HSA. Although qualified medical expenses generally exclude payment for insurance premiums, an exception is also provided for health coverage for a spouse or dependent during any period of continuation coverage. In addition, a similar exception is provided for the expense of coverage for a spouse or dependent during a period in which an individual is receiving unemployment compensation.

If an employee previously had coverage under an HSA-eligible HDHP, the employee can continue to make tax deductible HSA contributions provided the employee pays the "applicable premium" and such qualifying HDHP coverage continues. Since the HSA contribution limits are calculated on a monthly basis, the employee needs to ensure that the annual maximum HSA contribution has not already been reached before making additional contributions.

WHAT ABOUT RETIREMENT?

It has been estimated that a couple retiring at age 65 might need $200,000 or more to pay for health care costs after retirement. As previously mentioned, after you turn age 65, funds can be withdrawn from the HSA at any time and for any reason without penalty since the penalty is waived after age 65; however, if the withdrawn funds are used for something other than qualified medical expenses, the amount of such funds is subject to income tax. HSA funds can be used to pay premiums for Medicare Part A, B or D and for qualified long-term care insurance for the participant, spouse and dependents without being subject to tax; however, HSA funds may not be used to pay Medicare supplement insurance premiums.

Although Medicare premiums can be paid from existing HSA funds, no additional contributions can be made to an HSA after an individual becomes eligible *and* actually enrolled in Medicare Parts A, B, and/or D. According to IRC §223(b)(7), an individual who is enrolled in Medicare is not an eligible individual in any month during which the individual is enrolled in Medicare.

WHAT'S NEW WITH HSAs?

During 2008, a plethora of information regarding HSAs was released, including a detailed report from the U.S. Government Accountability Office ("GAO") regarding HSA participation; and, a significant amount of technical guidance from Treasury. According to findings from the April 2008 GAO study and related testimony provided on May 14, HSA-eligible plans increased from 438,000 in September 2004 to 6.1 million in January 2008. However, in spite of this rapid growth in qualifying HDHPs, 42 percent to 49 percent of the HSA-eligible enrollees from 2005 to 2007 did not open an HSA; and, just as amazing, 20 percent to 24 percent of the enrollees do not intend to open an HSA due to their inability to afford contributions, or a belief that they did not need one.

Based upon that statistic, it appears that the enrollees—whether as employees or as individual subscribers—were not provided with the necessary information to make the right decision to open an HSA. Although the health insurance industry could do a better job in educating its subscribers about the many financial benefits from opening an HSA, it appears that employers are also partly to blame for the lack of enthusiasm for HSAs. According to the Kaiser Family Foundation/Health Research and Education Trust 2007, two-thirds of employers offering single coverage through HSA-eligible HDHPs made no contributions to HSAs for their employees.

The GAO also reported some interesting income statistics with respect to HSA enrollees, based upon their detailed review of IRS data: the average adjusted gross income ("AGI") for HSA enrollees or those reporting HSA activity in 2005 was approximately $139,000, compared to $57,000 for other filers; and, 59 percent of HSA filers had an AGI of $60,000 or more, compared to 26 percent of other tax filers. Finally, with respect to HSA contributions and distributions in 2005: average contributions were $2,100, compared to average withdrawals of $1,000; and, 41 percent of the enrollees did not withdraw any HSA funds,

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compared to 22 percent that withdrew all or more than their reported contributions.

Although some commentators state that the income statistics cited by the GAO show that HSAs are a highly tax-advantaged savings vehicle for high income individuals with low expected use of health care, this should not be construed as a bad result. Those statistics seem to reflect an expected demographic in that older workers with higher AGIs and grown children would be more interested, as early adopters, in lower cost coverage provided under HSA-eligible HDHPs since they typically have more control over their health care costs than families with young children. Taking advantage of an opportunity to save for health care costs that are expected to be incurred during retirement is a good result.

The Treasury Department ("Treasury") and Internal Revenue Service ("IRS") have issued a significant amount of formal guidance since 2003 when HSAs were first created, and they have done an excellent job in responding to developing issues on a relatively timely basis. Most of this formal, technical guidance, as well as additional information regarding HSAs, including HSA Basics, FAQs, Fact Sheet: Dramatic Growth of HSAs, the 2009 HSA indexed amounts, and Labor Department guidance can be found on the Treasury—HSA Web site at: *http://www.treas.gov/offices/public-affairs/hsa/.*

The GAO report seems to indicate that HSAs are predominantly being utilized by wealthy individuals with AGIs greater than $60,000; however, the Treasury Fact Sheet puts a slightly different spin on it by stating that 42 percent of the individuals or families buying HSA type insurance on their own in 2005 had incomes below $50,000, and nearly 50 percent are age 40 or over. In addition, the Treasury Fact Sheet notes that 31 percent of the HSAs are held by previously uninsured individuals that are now buying their own health insurance. Similarly, 33 percent of the HSAs are being offered through small businesses that previously did not offer any health coverage.

During 2008, the HSA-specific technical guidance issued by the Treasury and the IRS included the following: final regulations under IRC §4980G (T.D. 9393, dated April 17); Revenue Procedure 2008-29, May 13, the 2009 HSA and HDHP indexed amounts; Notice 2008-51, June 3, one-time, tax-free transfer from IRA to HSA; Notice 2008-52, June 3, implements changes in the annual HSA contribution limits; and, Notice 2008-59, June 25, HSA "grab-bag" containing more than 40 new frequently asked questions and answers covering a wide-range of topics.

SO, WHAT'S THE FUTURE FOR HSAs?

For numerous reasons, HSAs make good sense from a health policy perspective, particularly during difficult economic times. Introducing consumer-driven supply and demand, and controlling health care inflation were key drivers for the initial legislation and those drivers are still important today, perhaps even more so. The premiums for qualifying HDHPs are typically 50 percent less than premiums for traditional first-dollar coverage. As a result, more employers will provide such coverage to their employees, and individuals are better able to afford some form of health coverage, as opposed to being uninsured.

Although many critics are concerned that wealthy enrollees will use HSAs to accumulate tax-advantaged savings, it is prudent to save for future health care costs that might be incurred during a period of employment, unemployment, or retirement. There are currently a number of unemployed individuals that likely would have appreciated the opportunity to fund an HSA with pre-tax dollars to help pay the COBRA premiums they are now paying.

According to the Treasury HSA Fact Sheet, based upon current law, there could be a total of 14 million HSA-eligible policies by 2010, covering 25 to 35 million people. Although there have been several legislative proposals that could impact the growth of HSAs, it appears there are no current proposals that would significantly encourage, or restrict, the growth of HSAs. Perhaps this will change.

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PROTECTED CELL (SERIES LLC) ARRANGEMENTS SHOULD CONSIDER SEGREGATION OF CORPORATE EARNINGS AND LIQUIDATION RIGHTS

By Lynlee C. Baker

In Notice 2008-19[1] and Rev. Rul. 2008-8[2] the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") provided guidance and requested comments on the circumstances under which a protected cell of a protected cell company (or a "Series" of a "Series LLC") would be treated as a separate insurance company for federal income tax purposes, and some of the consequences of such treatment as well as the treatment of a Series in a non-insurance context.[3] Recently, the American Bar Association Section of Taxation responded to the request for comments in Notice 2008-19 by submitting a letter detailing its members' recommendation (the "ABA Recommendation").[4] Interestingly, while both the Notice and the ABA Recommendation proposed separate entity treatment of each Series, neither required segregation of the traditional equity ownership rights, (*e.g.*, earnings and liquidation rights, in one Series from another). Without such segregation, if a Series is treated as a corporation for federal income tax purposes, it may be difficult to determine who is the owner of the equity interest, *i.e.*, stock, of each Series and whether such interest is common or preferred stock.[5] The following discussion summarizes the government guidance for protected cells in the insurance context and the ABA Recommendation, and comments on the Notice and ABA Recommendation in light of traditional notions of equity ownership for federal corporate income tax purposes.

REV. RUL. 2008-8

In Rev. Rul. 2008-8, the IRS described two arrangements, one between a protected cell and its participant ("Participant") ("cell-participant arrangement"), and another between a cell and multiple subsidiaries of its Participant ("cell brother-sister arrangement"). It analogized those arrangements to an arrangement between parent-subsidiary corporations and brother-sister corporations, respectively, in determining whether such arrangements constituted insurance for federal income tax purposes. The analysis is based on the IRS's position that "risk shifting" and "risk distribution" are both necessary elements to establish "insurance" for federal income tax purposes.[6] The IRS's established position is that risk shifting and risk distribution are not adequate in a parent-subsidiary arrangement if no unrelated risks are insured.[7] However, in brother-sister arrangements, the IRS has taken the position that the arrangement may qualify as "insurance," even if there are no unrelated risks, if the requisite risk shifting and risk distribution are present.[8]

Consistent with its established positions in connection with insurance arrangements between corporations, the IRS concluded that the cell-participant arrangement is not an insurance contract, but that the cell brother-sister arrangement is an insurance contract and the subsidiaries, which are brother-sister to the cell providing the insurance, may deduct amounts paid pursuant to the arrangement as "insurance premiums" under section 162. Although, the IRS did not explicitly conclude that the cells were separate entities for federal income tax purposes, the analysis used in Rev. Rul. 2008-8 presumes the cells are separate entities.

In the structure considered by the IRS in the Ruling, the protected cell company was a legal entity under the laws of the applicable jurisdiction, the common stock of which was owned by a sponsor. Multiple cells were within the protected cell company, none of which were treated as a legal entity distinct from the protected cell company under the laws of the applicable jurisdiction. At the same time, the income, expense, assets, liabilities and capital of each cell were accounted for separately from the protected cell company and the other cells, and the assets of each cell were statutorily protected from the creditors of any other cell and from the creditors of the protected cell company.

Each cell was identified with a specific Participant that funded their cell with capital contributions, and in turn, received nonvoting preferred stock of that cell. Participants also contributed "premiums" to their cell with respect to contracts issued by the cell, and the cell was required to pay out claims with respect to such contracts. The cell was entitled to make distributions with respect to the class of stock that corresponds to that cell, regardless of whether distributions were made with respect to any other class of stock. Significantly, in the event a Participant ceased its participation in the protected cell company, the Participant was entitled to a return of the assets

of the cell in which it participated, subject to any outstanding obligations of that cell. In its analysis, the IRS stated that all the income, expense, assets, liabilities and capital of the cell were separately accounted for and, upon liquidation, became the property of the Participant, who was the sole shareholder with respect to the cell. However, the Ruling cautioned that the terms "common stock" and "preferred stock" as used in the protected cell company and cell instruments do not necessarily reflect the federal income tax status of those instruments.

NOTICE 2008-19

In Notice 2008-19, issued in connection with the issuance of the Ruling, the Treasury and the IRS proposed a rule under which a cell of a protected cell company would be treated as an insurance company separate from any other entity if:

1. The assets and liabilities of the cell are segregated from the assets and liabilities of any other cell and from the assets and liabilities of the protected cell company such that no creditor of any other cell or of the protected cell company may look to the assets of the cell for the satisfaction of any liabilities, including insurance claims (except to the extent that any other cell or the protected cell company has a direct creditor claim against such cell); and

2. Based on all the facts and circumstances, the arrangements and other activities of the cell, if conducted by a corporation, would result in its being classified as an insurance company within the meaning of sections 816(a) or 831(c).

However, there was no explicit requirement that limited the equity ownership rights in each protected cell to the earnings or liquidation value of that protected cell.

ABA RECOMMENDATION

In Notice 2008-19, the Treasury and the IRS also requested comments on the proposed guidance, including comments relating to what guidance, if any, would be appropriate concerning similar segregated arrangements that do not involve insurance. In response to that request, the ABA Tax Section recommended that guidance should be issued confirming that each Series of an LLC (or the LLC itself) is a separate "business entity" for purposes of Treas. Reg. § 301.7701-2(a), assuming that certain minimum requirements are met. Under the ABA Recommendation, in order to be treated as a separate business entity, the Series must (i) be formed under a statute having characteristics such as those contained in the Delaware Limited Liability Company Act, Del. Code Ann. tit. 6, section 18-215 (2007) ("Delaware Series LLC Provision"), and (ii) satisfy applicable record keeping and notice requirements so that the liabilities of a particular Series may only be enforceable against that Series' assets.

The Delaware Series LLC Provision provides that an LLC agreement may establish one or more designated Series of members, managers, limited liability company interests or assets. Generally, under the Delaware Series LLC Provision:

1. A Series may have separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations.

2. A Series may have a separate business purpose or investment objective.

3. Provided that certain notice and recordkeeping requirements are satisfied, the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular Series shall be enforceable against the assets of such Series only, and not against the assets of the LLC generally or any other Series thereof, and, none of those with respect to the LLC generally or any other Series thereof shall be enforceable against the assets of such Series.

4. Each Series shall have the power and capacity to, in its own name, contract, hold title to assets, grant liens and security interests, and sue and be sued.

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Because the Delaware Series LLC Provision provides that each Series may have separate rights, powers or duties with respect to specified property, obligations or profits and losses associated with specified property or obligations, there appears to be no explicit requirement in Delaware law that would limit the equity ownership rights in each Series to the earnings or liquidation value of that Series.

If the Treasury and the IRS accept the ABA Recommendation, and each Series is treated as an "eligible entity" under the check-the-box regime (Treas. Reg. § 301.7701-1 through Treas. Reg. § 301.7701-3), a Series could elect to be an association taxable as a corporation.

COMMENTS

If, as proposed in Notice 2008-19 and the ABA Recommendation, a protected cell is treated as a separate entity and corporate tax treatment is contemplated, taxpayers should consider segregating the traditional equity ownership rights, *e.g.*, earnings and liquidation rights, in one Series from another. Therefore, if the applicable LLC statute does not necessarily provide for this result, taxpayers should consider such a provision in the Series LLC agreement when tax treatment of a Series as a corporation for federal income tax purposes is contemplated.

In general, an equity interest in an organization treated as a corporation for federal income tax purposes implicates three basic rights: (1) the right to vote and thereby to exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation.[9] Based on this general principle, the IRS has taken the position that certain Series stock may be neither common stock nor preferred stock, but some type of "special stock." In Rev. Rul. 54-65, 1954-1 C.B. 101, the IRS held that where each Series of a registered investment company was wholly dependent for its earnings and liquidating value upon entirely different underlying assets from any other Series, an exchange of one Series for another did not qualify as an exchange of common shares for common shares or preferred shares for preferred shares under the predecessor to section 1036, as set forth in the Internal Revenue Code of 1939.

Accordingly, without a requirement that limits the corporate equity ownership rights in each Series to the earnings and liquidation value of that Series, identification of the stockholders could become difficult to discern because individuals having an equity interest in one Series may also have varying degrees of equity interests in another Series, creating cross-ownership patterns among the Series. Moreover, the classification of the equity interest as common stock or preferred stock would be in question.

The IRS appears to have recognized these potential issues in Rev. Rul. 2008-8 and a private letter ruling.[10] In Rev. Rul. 2008-8, the IRS's conclusions were dependent upon the ownership analogies between the cell arrangements and the parent-subsidiary and brother-sister subsidiaries arrangements. Not surprisingly, in its analysis, the IRS relied on the fact that all the income, expense, assets, liabilities and capital of each of the cells was separately accounted for and, upon liquidation, become the property of the Participant, who was the sole shareholder with respect to each cell. At the same time, in connection with the preferred stock owned by the Participant, the ruling cautioned that terms "common stock" and "preferred stock" as used in the protected cell company and cell instruments do not necessarily reflect the federal income tax status of those instruments.

In PLR 200803004, the IRS ruled generally that each Series of an LLC, which was an open-end management investment company formed by an insurance company to hold assets in connection with variable insurance products, should be classified as a separate business entity for federal tax purposes. The ruling included several classification rulings which were dependent upon the numbers of shareholders of each Series for federal income tax purposes. For example, in connection with one of the Series, the IRS ruled that the Series would be classified as an entity disregarded as an entity separate from its owner unless it makes an election to be treated otherwise. Under the entity classification regulations, such a ruling is dependent upon the existence of a single shareholder, hence, identification of the owners of the equity interests. The IRS did not rule on this issue, however. The private ruling was

predicated upon the representations that (i) the shareholders of a Series may share in the income only of that Series; (ii) the ownership interest of the shareholders of a Series will be limited to the assets of that Series upon redemption, liquidation or termination of such Series; and (iii) each of the insurance companies that purchased shares of a Series will be treated as the owner of those shares for federal income tax purposes.

It will be interesting to see whether the Treasury and the IRS will continue to rely on representations, or will provide Series LLC guidance that requires segregation of the traditional equity ownership rights, *e.g.*, earnings and liquidation rights, in one Series from another, in both the insurance and non-insurance context. Regardless, however, it would be prudent for Series LLC arrangements in the insurance context to consider segregation of the earnings and liquidation rights of each Series, if the relevant statute does not otherwise so provide, when tax treatment of a Series as a corporation for federal income tax purposes is contemplated.

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END NOTES

1. 2008-5 I.R.B. 366.
2. 2008-5 I.R.B. 340.
3. For other discussions relating to Notice 2008-19 and Rev. Rul. 2008-8, *see* "Protected Cells As Insurance Companies," Mark H. Kovey, *TAXING TIMES*, May 2008, and "Tax Factors Influence the Viability of NAIC Securitization Initiatives," Emanuel Burnstein, *TAXING TIMES*, September 2008.
4. *See* Letter from American Bar Association, Tax Section (January 5, 2009), regarding *Notice 2008-19 and Segregated Arrangements That Do Not Involve Insurance*, 2009 TNT 2-56.
5. This suggestion is equally applicable to a Series LLC treated as an entity separate from each of its Series.
6. Rev. Rul. 2008-8; Rev. Rul. 2002-90, 2002-2 C.B. 985. The term "insurance" is not defined in the Internal Revenue Code. In *Helvering v. LeGierse*, 312 U.S. 531, 539 (1941), the Supreme Court addressed the issue of the scope of insurance for tax purposes, noting that "[h]istorically and commonly insurance involves risk-shifting and risk distributing."
7. Rev. Rul. 2008-8, *supra*, Note 2.
8. *Id.*
9. *Paulsen v. Commissioner*, 469 U.S. 131, 138 (1985); *Himmel v. Commissioner*, 338 F.2d 815, 817 (2nd Cir. 1964).
10. PLR 200803004 (Oct. 15, 2007).

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SURPRISING INVESTOR CONTROL ADVICE FROM IRS

By Joseph F. McKeever and Bryan W. Keene

Last October, the Internal Revenue Service ("IRS") released chief counsel advice memorandum 200840043 (the "CCA Memo"), addressing the "investor control" doctrine. The CCA Memo concludes that "[w]here a segregated asset account directly invests in assets available to the general public, the policyholder … is the owner of the assets in the segregated asset account." Taken at face value, this conclusion suggests that the IRS believes that any segregated asset account ("SAA") that is comprised of a pool of individual securities (such as a traditional "managed account" within the issuer's separate account), rather than shares of an "insurance-dedicated" mutual fund or partnership, will run afoul of the investor control doctrine. As discussed in this article, such a conclusion would be deeply flawed based on the administrative, congressional, and judicial precedents involving the investor control doctrine. As a result, it is possible that other facts described in the CCA Memo but not addressed in its analysis might have affected the ultimate conclusion. Nonetheless, the conclusion is troubling given that managed separate accounts have long been utilized in connection with variable contracts.

BACKGROUND ON THE INVESTOR CONTROL DOCTRINE

For federal income tax purposes, a life insurance company normally is treated as the owner of the separate account assets it holds in support of variable annuity and life insurance contracts it issues. The IRS established a limited exception to this treatment, however, in a series of revenue rulings colloquially known as the "investor control" rulings.[1] Under those rulings, the policyholder, rather than the insurance company, is treated as the owner of the separate account assets if he or she has sufficient incidents of ownership in them. The result is that the tax benefits of the insurance contract are lost, and the policyholder is currently taxable on income generated by the separate account assets.

The investor control rulings are predicated on the view that an investor should not be able to choose between purchasing a security directly, thereby subjecting the earnings to current taxation, or "wrapping" the investment in a variable contract, thereby deferring current taxation on those earnings. To this end, the rulings reflect the view that the party who directs the selection, management, and disposition of the assets of a SAA typically will be considered the owner of those assets for federal income tax purposes.[2]

In applying this principle, the investor control rulings often focus on the "public availability" of the investments supporting the contract. If the same investment is available without regard to the contract, *i.e.*, if it is publicly available, and the policyholder can either directly or indirectly instruct the insurance company to purchase that investment, then the policyholder has sufficient incidents of ownership in the investment to be viewed as its owner for tax purposes. Of course, almost every individual asset held in support of a variable contract (stocks, bonds, *etc.*) is "publicly available" at some level. As a result, the doctrine cannot reasonably be viewed as focusing only on whether any *particular* investment is publicly available—if this was the standard, virtually no variable contract would pass muster under the doctrine. Rather, the investor control analysis has focused—and should focus—on whether, in the aggregate, the assets supporting the contract represent a pool of investments that is available only through the purchase of a variable insurance product. Insurance-dedicated mutual funds and partnerships can pool publicly available assets together in this manner, but so can traditional managed separate accounts.

THE CCA MEMO IN GENERAL

The CCA Memo describes a private letter ruling request that the taxpayer-insurer withdrew after the IRS reached a tentative adverse position. In such situations, applicable IRS procedures authorize the IRS Chief Counsel's Office to send a memorandum to the IRS field office with jurisdiction over the taxpayer's return to inform the field of the withdrawn ruling request and the Chief Counsel Office's negative views thereon.[3] Like a private letter ruling, a chief counsel advice memorandum has no precedential value; it cannot be cited or relied upon as precedent.[4]

THE FACTS INVOLVED IN THE WITHDRAWN RULING REQUEST

The taxpayer was a foreign insurer that made an election to be treated as a domestic insurer pursuant to section 953(d). It filed, then withdrew, a ruling request with the IRS regarding variable contracts it intended to issue. Each contract was to be based on a different SAA that the taxpayer would establish for that contract. The CCA Memo explains that the policyholder could recommend the investment advisor for the SAA and, subject to certain limitations, the insurer would accept the recommendation. The policyholder also could complete a questionnaire regarding "investment horizons, investment goals, risk tolerance, risk profile, comfort with investments in different regions (*i.e.*, Latin America, Eastern Europe, Far East, Western Europe, Australia), and comfort level with different types of investment vehicles (*e.g.*, real estate, ADR's, partnerships, etc.)." Other than this information, there would be no agreements or communications between the policyholder and the insurer or the investment advisor regarding the SAA's investments, and the investment advisor would make all investment decisions in its "sole and unfettered discretion." Finally, and apparently most important to the IRS analysis, the parties "anticipated that the segregated asset accounts will directly invest in assets available to the general public."

Based on these facts, the insurer requested rulings that (1) for federal tax purposes it would be treated as the owner of the assets comprising the SAA, and (2) the contracts would constitute variable contracts within the meaning of section 817(d). The IRS reached a tentative adverse position on the first requested ruling. This prompted the taxpayer to withdraw its entire request, which made it unnecessary for the IRS to address the section 817(d) issue.

THE IRS ANALYSIS AND CONCLUSION

The CCA Memo summarizes most of the various court cases and IRS rulings that address the investor control doctrine, including *Christoffersen v. United States*, Rev. Rul. 81-225, and Rev. Rul. 2003-92 (but, curiously, not Rev. Rul. 2003-91). The CCA Memo offers very little analysis of those authorities in the context of the facts presented. Rather, after summarizing those authorities the CCA Memo states only that "[u]nder Rev. Rul. 81-225, assets held directly by a segregated asset account that are available to the general public are owned by the policyholder for federal tax purposes. For this reason, we believe that the policyholder in the ruling request and not the Taxpayer would own the assets in the proposed segregated asset accounts for federal tax purposes."

OBSERVATIONS

Historically, it was quite common for a SAA that supports a variable contract to hold individual securities—each of which is publicly available—rather than shares of an "insurance-dedicated" mutual fund, partnership or trust. The first variable annuity contract, developed by TIAA-CREF, was based on such a "managed account," as were the variable annuities at issue in *VALIC* when the Supreme Court concluded that variable annuities were securities.[5] Indeed, a number of insurance company separate accounts continue to follow this approach today, as evidenced by SEC registration filings.[6] The CCA Memo, however, suggests that such an approach violates investor control principles on its face, and that the only way to avoid such a result is to interpose an insurance-dedicated mutual fund, partnership or trust between the SAA and the individual securities that the SAA otherwise would hold. In our view, this conclusion is erroneous.

First, it was not the public availability of individual securities that caused an investor control problem to arise in the

CONTINUED ON **PAGE 32**

Historically, it was quite common for a SAA that supports a variable contract to hold individual securities—each of which is publicly available—rather than shares of an "insurance-dedicated" mutual fund, partnership or trust.

various IRS rulings. Rather, it was the policyholder's ability to pick *which* publicly available securities would support the contract. Thus, for example, in Rev. Rul. 77-85 the policyholder's ability to direct the SAA to sell, purchase, and exchange investments that the policyholder selected from an approved list of publicly traded securities and bank deposit instruments caused an investor control problem to arise. Likewise, in Rev. Rul. 80-274 the policyholder's ability to purchase and transfer specific certificates of deposit to the SAA supporting his variable contract created an investor control problem. Similarly, in Rev. Rul. 81-225, from which the CCA Memo draws its conclusion, it was the policyholder's ability to allocate cash values to purchase shares of a specific publicly available mutual fund that caused the problem. In each of these rulings, impermissible investor control arose because the policyholder could direct which publicly available assets the SAA would purchase or sell. By concluding that it was the public availability of the assets themselves that caused the problem, and not the policyholder's ability to pick and choose those assets, the CCA Memo overlooks this fundamental aspect of the investor control analysis.

Second, the CCA Memo is at odds with the IRS's analysis and conclusion in Situation 5 of Rev. Rul. 81-225. Situation 5 is premised on the view that the direct holding of individual securities in a separate account is consistent with the insurer—not the policyholder—being treated as the owner of the securities for federal tax purposes. In Situation 5, the SAA invested in shares of a mutual fund (the "XY Fund"), the shares of which were available only through the purchase of an annuity contract. Rev. Rul. 81-225 concludes that in Situation 5 the insurance company ("IC")—and not the policyholder—is the owner of the mutual fund shares for tax purposes. The IRS explained its conclusion as follows:

> In *Situation* 5, the shares of XY Fund are not separate investment assets; XY Fund is nothing more than the alter ego of IC. The sole function of XY Fund is to provide an investment vehicle to allow IC to meet its obligations under its annuity contracts. *This situation is equivalent for federal income tax purposes to the direct purchase by IC of the underlying portfolio of assets of XY Fund. IC possesses sufficient incidents of ownership to be considered the owner of these underlying assets for federal income tax purposes.* (Emphasis added.)

It is obvious from this reasoning that the authors of Rev. Rul. 81-225 believed that the direct holding of individual securities by the insurer did not by itself create an investor control problem. Indeed, it seems clear that the premise of the IRS conclusion that Situation 5 did not violate the investor control doctrine was that it was equivalent to direct ownership by the insurer of the underlying assets (which were, of course, individual securities such as stocks and bonds that are "publicly available"). And, given the prevalence of managed separate accounts in the early 1980s, this premise is not surprising.

Furthermore, the conclusion in the CCA Memo appears to contradict section 817(h) and the regulations thereunder. Congress enacted section 817(h) to deny annuity or life insurance treatment for "contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (*e.g.*, stocks, bonds, or certificates of deposit of a single issuer); [or] (2) that invest in one or a relatively small number of publicly available mutual funds …"[7] This legislative history makes it clear that a SAA supporting a variable contract can directly hold individual securities or shares of public mutual funds, as long as such holdings meet the diversification requirements.

In addition, section 817(h)(3), which provides a special rule for variable life insurance contracts, clearly contemplates that a SAA can directly hold U.S. Treasury securities, which are obviously publicly available securities. In this regard, section 817(h)(3) states "to the extent that any segregated asset account with respect to variable life insurance con-

tracts *is invested in securities issued by the United States Treasury, the investments made by such accounts shall be treated as adequately diversified."* (Emphasis added.)

Consistently, examples in the section 817(h) regulations conclude that a contract will satisfy section 817(h) where the contract is based on one or more SAAs that hold individual, publicly available securities.[8] The CCA Memo's suggestion that a SAA must invest only in insurance-dedicated mutual funds, partnerships or trusts would render these provisions meaningless.

Finally, an unusual aspect of the CCA Memo is its lack of any discussion of Rev. Rul. 2003-91. In that ruling, the IRS identified certain favorable facts that would help avoid a finding of impermissible investor control, including the policyholder's inability to (1) select or even communicate views about the initial or subsequent investment advisor for the SAA, (2) recommend particular investments or investment strategies, or (3) communicate with the investment advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in the SAA. As indicated above, the facts of the CCA Memo state that the policyholder could select the investment advisor for the SAA, complete a questionnaire that would help the investment advisor develop an investment strategy for the SAA, and identify certain classes of assets (including by region) that the policyholder wished to include in (or exclude from) the SAA. Given the lack of any discussion of Rev. Rul. 2003-91 or any analysis of these facts in the CCA Memo, it is unclear whether or to what extent such facts influenced the IRS conclusion. However, given the deficiencies of a conclusion that a separate account which invests in publicly available securities has necessarily violated the investor control doctrine, it may be that these other factors played a role—albeit unstated—in the IRS decision not to rule favorably and to then issue the CCA Memo.

CONCLUSION

So, where does that leave us? To the extent that the CCA Memo reflects the view that a separate account which invests in publicly available securities has *ipso facto* violated the investor control doctrine, the CCA Memo is inconsistent with Rev. Rul. 81-225 and section 817(h) and its regulations. However, taxpayers who are filing ruling requests involving variable contracts should proceed cautiously if their separate accounts do not use a pass-through entity and instead invest directly in individual securities. Otherwise, they may find themselves the subject of a future chief counsel advice memorandum.

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END NOTES

1 Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12, modified by Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12. *See also* Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

2 The investor control rulings state that this view is based on the judicial notion that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Rev. Rul. 2003-91 (quoting Corliss v. Bowers, 281 U.S. 376 (1930)). This notion, in turn, is a specific application of the long-standing judicial doctrine that the substance of an arrangement, rather than its form, controls its characterization for federal tax purposes. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935).

3 Section 7.07(2) of Rev. Proc. 2009-1, 2009-1 I.R.B. 1, 28.

4 I.R.C. section 6110(k)(3). Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended.

5 *See* Securities and Exchange Commission v. Variable Annuity Life Ins. Co. of America, 155 F.Supp. 521, 523 (D.D.C. Sep. 3, 1957), *aff'd*, 257 F.2d 201 (D.C. Cir. 1958), *rev'd*, 359 U.S. 65 (1959). *See also* Securities and Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

6 It is, however, far more common today for registered variable contracts to be based on insurance-dedicated funds rather than managed separate accounts. As a result, the position reflected in the CCA Memo likely has more significance for private placement products, which use managed separate accounts more often.

7 H.R. CONF. REP. NO. 98-861, at 1055 (1984).

8 *See* Treas. Reg. section 1.817-5(g), Example (1) (concluding that section 817(h) is satisfied where a contract is supported by two SAAs, one of which holds a diversified pool of debt securities and the other of which holds interests in an insurance-dedicated partnership that, in turn, holds a diversified pool of securities). *See also* Treas. Reg. section 1.817-5(g), Example (3) (reaching the same conclusion with respect to a single SAA that holds individual debt securities and interests in a publicly-available partnership, as long as the debt securities and the partnership interests, considered together, are adequately diversified).

THE TEMPORARY (AND LIMITED) WAIVER OF THE RMD RULES FOR 2009

By Mark E. Griffin

Steps that Congress took late last year in response to the economic crisis included amending the minimum distribution requirements under section 401(a)(9)[1] by enacting new section 401(a)(9)(H), and making a related amendment to the tax-free rollover rules under section 402(c), as part of the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA").[2] In general, these amendments temporarily waive the minimum distribution requirements for 2009 and permit payments that otherwise would be required minimum distributions ("RMDs") for 2009 to be rolled over tax free. As discussed below, this temporary waiver provides only limited relief from the section 401(a)(9) minimum distribution requirements, and it is doubtful that this relief will be expanded legislatively.

The Internal Revenue Service ("IRS") already has issued one piece of guidance, Notice 2009-9,[3] which clarifies the reporting requirements with respect to RMDs from IRAs for 2009. However, as discussed below, a number of issues remain about how this 2009 RMD relief operates. These issues include questions about the application of this relief to amounts that are automatically paid as RMDs each year, amounts under an IRA that are paid as RMDs more frequently than annually, and amounts that are paid as RMDs in the form of annuity payments. There also are questions about whether plans and contracts need to be amended in order to provide this temporary relief. In addition, the 2009 RMD relief might impact certain annuity benefits that interact with the section 401(a)(9) minimum distribution requirements, such as guaranteed minimum withdrawal benefits that are offered under variable deferred annuity contracts that are issued as IRA and section 403(b) contracts.

SECTION 401(A)(9) IN GENERAL

Section 401(a)(9) imposes minimum distribution requirements that apply to an individual's interest in a qualified plan under section 401(a) (including a defined contribution plan and a defined benefit plan), qualified annuities under section 403(a), section 403(b) contracts (including a custodial account under section 403(b)(7)), IRAs (including a traditional IRA account, traditional IRA annuity contract, Roth IRA, SEP IRA and SIMPLE IRA), and governmental section 457(b) arrangements. Minimum distributions under this section are required to commence on or before the individual's "required beginning date," *i.e.*, generally April 1 of the calendar year following the later of (1) the calendar year in which the individual attains age 70½, and (2) except in the case of an IRA, the calendar year in which the individual retires.[4] If the individual dies on or after the required beginning date, any remaining interest in the arrangement must be distributed to the "designated beneficiary" (within the meaning of section 401(a)(9)) at least as rapidly as under the method of distribution in effect at the time of the individual's death (the "at-least-as-rapidly rule").[5] If the individual dies prior to the required beginning date, any remaining interest must be distributed to the designated beneficiary either (1) no later than December 31 of the calendar year containing the fifth anniversary of the individual's death (the "five-year rule"), or (2) over the beneficiary's life or life expectancy, commencing no later than December 31 of the calendar year following the calendar year of the individual's death (the "lifetime distribution rule").[6]

The regulations under section 401(a)(9) set forth two sets of rules for determining the amount of the RMD for a calendar year, depending on whether the arrangement is in the form of an individual account or an annuity contract.[7] If an individual is not taking RMDs in the form of an annuity that satisfies the annuity rules under the regulations, the RMD for a calendar year is determined under the individual account rules by dividing the "account balance" at the end of the previous calendar year by the applicable distribution period set forth in the regulations.[8]

In the case of an IRA, a non-spouse designated beneficiary may not roll over an amount received under a deceased owner's IRA, *i.e.*, an "inherited IRA."[9] A designated beneficiary who is the surviving spouse of the deceased IRA owner may elect to continue the IRA as his or her own, thereby delaying

the after-death distribution requirements until the surviving spouse dies.[10] Also, the trustee, custodian or issuer of an IRA (collectively, the "issuer") is required to report information with respect to RMDs from the IRA for each calendar year, as required by the IRS.[11] In this regard, Notice 2007-27,[12] provides that if a minimum distribution is required with respect to an IRA for a calendar year and the IRA owner is alive at the beginning of the year, the issuer must provide a statement to the IRA owner by January 31 of the calendar year that either (1) states the amount of the RMD for the calendar year and the date by which it must be distributed, or (2) informs the IRA owner that an RMD is required for the calendar year and the date by which the amount must be distributed, and offers to calculate the RMD upon request. For each calendar year that an issuer maintains an IRA, the issuer must provide the IRA owner and the IRS with a Form 5498, *IRA Contribution Information*, and must check box 11 on the form if an RMD with respect to the IRA is required for the following calendar year.

NEW SECTION 401(A)(9)(H)

The section 401(a)(9) minimum distribution requirements are designed generally to provide for the systematic liquidation of retirement savings that have been accumulated under certain tax-favored retirement arrangements. Unfortunately, the current economic crisis has resulted in significant losses in individuals' retirement savings. Many retired individuals are now concerned that their savings will be insufficient to provide for their retirement needs.

In response to this concern, new section 401(a)(9)(H) has been added to the Code, temporarily waiving the minimum distribution requirements for 2009. This 2009 RMD relief applies to IRAs and employer-provided qualified retirement plans that are defined contribution plans within the meaning of section 414(i), *i.e.*, defined contribution plans described in sections 401(a), 403(a), and 403(b), and governmental section 457(b) plans.[13] This relief applies to lifetime RMDs to employees and IRA owners, as well as to after-death RMDs to beneficiaries.[14]

For purposes of applying the minimum distribution requirements for calendar years after 2009, an individual's required beginning date is determined without regard to the relief.[15] So, for instance, if 2009 is the first year for which an individual must take an RMD, so that the individual's required beginning date is April 1, 2009, no RMD for 2009 is required to be made by that date. However, new section 401(a)(9)(H) does not change the individual's required beginning date for purposes of determining RMDs for calendar years *after* 2009. Thus, the RMD for 2010 still must be made no later than Dec. 31, 2010. Also, if the individual dies on or after April 1, 2010, any remaining interest of the individual must be distributed under the after-death distribution rules that apply when the individual dies on or after the required beginning date, *i.e.*, in accordance with the at-least-as-rapidly rule.[16]

> Unfortunately, the current economic crisis has resulted in significant losses in individuals' retirement savings. Many retired individuals are now concerned that their savings will be insufficient. …

Also, for purposes of the five-year rule that applies in the event of death prior to the required beginning date, described above, the five-year period is determined without regard to calendar year 2009.[17] Thus, for example, if an individual died in 2007, the five-year period that otherwise would expire at the end of 2012 is extended by the 2009 RMD relief through 2013.[18]

The 2009 RMD relief is effective for calendar years beginning after Dec. 31, 2008. However, if 2008 is the first calendar year for which an individual must take an RMD, so that the individual's required beginning date is April 1, 2009, the 2009 RMD relief does not apply to the RMD for 2008 that must be made on or before the required beginning date in 2009. The individual still must take the full 2008 RMD no later than April 1, 2009.[19]

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In early January, the IRS issued Notice 2009-9, which provides the following three bits of guidance regarding the RMD reporting requirements with respect to IRAs:

1. Notice 2009-9 clarifies that for IRA issuers required to file a Form 5498 for 2008, box 11 of the form, indicating that an RMD is required for 2009, should not be checked. The IRS recognized that IRA issuers had only a short amount of time to make programming changes necessary to reflect this guidance. Accordingly, the Notice provides that if an IRA issuer issued a 2008 Form 5498 with a check in box 11, the IRS will not consider the form as issued incorrectly if the issuer notifies the IRA owner no later than March 31, 2009, that no RMD is required for 2009.

2. Notice 2009-9 modifies the requirements in Notice 2002-27 that apply if an IRA owner is required to take a minimum distribution for a calendar year. As noted above, the issuer must provide a statement to the IRA owner by January 31 of a calendar year, generally indicating the amount of the RMD for the year or offering to calculate the RMD for the year. Notice 2009-9 clarifies that the issuer need not provide this statement for 2009. If the issuer does send an RMD statement to an IRA owner, either initially or in response to the owners request that the issuer calculate the RMD for 2009, the issuer must show the 2009 RMD as zero. Alternatively, the issuer may send the IRA owner a statement showing the RMD that would have been required absent new section 401(a)(9)(H), together with an explanation of the 2009 RMD relief.

3. Notice 2009-9 states that all IRA issuers are "encouraged" to inform IRA owners who delay taking their 2008 RMD until April 1, 2009, that they are still required to take these RMDs on or before that date. It is interesting to note the WRERA neither requires nor encourages that notice of the 2009 RMD relief be given to taxpayers.

TAX-FREE ROLLOVER TREATMENT

The Code provides similar, but different, tax-free rollover rules for (1) "eligible rollover distributions" from qualified plans under section 401(a), qualified annuities under section 403(a), section 403(b) contracts, and governmental section 457(b) plans ("non-IRA plans") and (2) distributions from IRAs. An "eligible rollover distribution" from a non-IRA plan can be rolled over tax free within 60 days to an "eligible retirement plan," *i.e.*, a non-IRA plan or an IRA.[20] An eligible rollover distribution is defined in section 402(c)(4) as any distribution to an employee of all or any portion of the balance to the credit of the employee, except that an eligible rollover distribution does not include:

1. any distribution which is one of a series of substantially equal periodic payments made at least annually for (a) the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and the employee's designated beneficiary, or (b) a specified period of 10 years or more (a "SEPP distribution"),

2. any distribution to the extent it is an RMD, and

3. any distribution which is made upon hardship of the employee (a "hardship distribution").

If an eligible rollover distribution is made from a non-IRA plan, an amount equal to 20 percent of the distribution must be withheld under section 3405(c) unless the distribution is directly rolled over to an eligible retirement plan. In addition, section 402(f) requires that notice of the rollover rules and mandatory 20 percent withholding requirement must be provided to individuals within a reasonable period of time before an eligible rollover distribution is made. (The rules described herein relating to eligible rollover distributions do not apply to distributions from IRAs.)

WRERA amends the definition of an eligible rollover distribution by adding at the end of section 402(c)(4) language that addresses the tax-free rollover of amounts that otherwise would be RMDs for 2009, and thus otherwise would be ineligible for tax-free rollover treatment. In particular, a distribution from a non-IRA plan for 2009 that would be an RMD for the year, if not for the 2009 RMD relief, nevertheless can be treated as an eligible rollover distribution if it otherwise qualifies as such, *i.e.*, it is not a SEPP distribution or a hardship distribution. The WRERA amendment clarifies that such an eligible rollover distribution will not be subject to the mandatory 20 percent withholding requirement or the section 402(f) notice requirement that otherwise apply to eligible rollover distributions.

> For example, if a non-IRA plan distributed an amount to an individual for 2009, the plan is permitted—*but is not required*—to offer the employee a direct rollover of that amount and provide the employee with a written explanation of the requirement. If the employee receives the distribution, it would not be subject to the mandatory 20 percent withholding requirement, and the employee could roll over the distribution by contributing to an eligible retirement plan within 60 days of the distribution.[21]

As mentioned above, these eligible rollover rules do not apply to distributions from an IRA. However, section 408(d)(3) provides generally that, subject to certain limitations and exceptions, a distribution from an IRA can be rolled over tax free within 60 days to an eligible retirement plan, *i.e.*, a non-IRA plan or another IRA. Like RMDs from non-IRA plans, RMDs from IRAs are not entitled to tax-free rollover treatment.[22] Also, under the "one-year rule" set forth in section 408(d)(3)(B), if an individual makes a tax-free rollover of a distribution from an IRA, the individual may not make another tax-free rollover of another distribution from that same IRA within a one-year period.

CERTAIN PRACTICAL LIMITATIONS OF THE 2009 RMD RELIEF

It is important to recognize that WRERA provides only limited relief from the section 401(a)(9) required minimum distribution rules. WRERA does not provide RMD relief for 2008, in which the impact of the economic crisis has been perhaps the most substantial. This is because under the individual account rules, mentioned above, an individual's RMD with respect to an eligible retirement plan for 2008 is determined by dividing the individual's account balance in the plan as of the end of 2007 by the applicable distribution period set forth in the regulations. Because of the substantial losses incurred by individuals in 2008, they experienced dramatic drops in the account balances of their eligible retirement plans during the year. As a result, an individual's RMD for 2008, which was determined based on the pre-crisis 2007 year-end account balance, likely is disproportionately high when considered in connection with the individual's 2008 year-end account balance. However, the RMD relief provided by WRERA applies only for 2009.

In December of last year, Senator Olympia Snowe (R-ME) introduced a bill (S. 3719) that would provide RMD relief for 2008-2010, and Senator Arlen Specter (R-PA) introduced a bill (S. 3720) that would provide RMD relief for 2008 and 2009. No action was taken on either bill. In January, Senators Snowe and Blanche Lincoln (D-AR) introduced a bill (S. 157), and Representative Tim Murphy (R-PA) introduced a bill (H.R. 424), that would provide RMD relief for 2009. However, it appears unlikely that further RMD relief will be forthcoming legislatively.

Also, new section 401(a)(9)(H) will only provide relief to those individuals who are wealthy enough that they do not need to take distributions of amounts that otherwise would be required to be distributed for 2009. Put differently, even though RMD relief is available for 2009, individuals' finances might be such that they must nevertheless take distributions for the year, and thus are unable to take advan-

CONTINUED ON **PAGE 38**

tage of the relief. These individuals would benefit from alternative forms of relief that were mentioned at one time or another, but that never found its way into legislation, such as a proposal that would allow individuals to take RMDs and exclude them from gross income.[23]

Moreover, in certain circumstances discussed below, even if a retired individual taking RMDs does not have a need financially to take a distribution for 2009, the RMD relief might be unavailable, and thus the individual nevertheless might be forced to take the distribution for the year.

INABILITY TO ROLL OVER SEPP DISTRIBUTIONS

As explained above, to the extent that a distribution from a non-IRA plan would be an RMD but for the 2009 RMD relief, the recipient may roll over the distribution tax free to another non-IRA plan or an IRA if the distribution otherwise qualifies as an "eligible rollover distribution," *i.e.*, it is not a SEPP distribution or a hardship distribution. Hence, a distribution from a non-IRA plan will not qualify for tax-free rollover treatment if it is one of a series of substantially equal periodic payments made at least annually for life or life expectancy (or joint lives or joint life expectancy) or for a specified period of at least 10 years. If a taxpayer makes a separate request each year for a withdrawal of the RMD amount for the year, each year's distribution generally is not treated as one of a series of SEPP distributions and can qualify for tax-free rollover treatment.

However, it seems that RMDs from a non-IRA plan that are made in the form of annuity payments, discussed further below, will not qualify as eligible rollover distributions, except in limited circumstances in which they are paid for a period certain of less than 10 years. It also seems that non-annuity RMD distributions that are automatically determined and paid each year, *e.g.*, under a systematic withdrawal option selected by the owner of a section 403(b) deferred annuity contract, constitute SEPP distributions that do not qualify for eligible rollover distribution treatment. This is because such automatic distributions for a year commonly are computed by dividing the previous year-end account balance by a particular distribution period (such as the applicable period from the Uniform Lifetime Table under Treas. Reg. section 1.401(a)(9)-9, Q&A-2), and such distributions generally are considered SEPP distributions for purposes of the eligible rollover distribution rules.[24] Hence, it appears that absent guidance to the contrary, a taxpayer receiving such periodic payments will be unable to take advantage of the 2009 RMD relief unless the payments are suspended or modified so that they are no longer treated as constituting SEPP distributions.

QUESTIONS ABOUT ANNUITY PAYMENTS

New section 401(a)(9)(H) provides a waiver of the section 401(a)(9) minimum distribution rules for 2009 to certain defined contribution plans and IRAs. On its face, this 2009 RMD relief can be read as applying to annuity payments made under such arrangements. If the 2009 RMD relief does apply to annuity payments, then absent guidance, an individual's ability to roll over the payments tax free is limited by:

1. the requirement that tax-free rollover treatment for eligible rollover distributions from a non-IRA plan does not apply to certain distributions, like typical RMD annuity payments, which are SEPP distributions,
2. the requirement that only one distribution from an IRA can be rolled over tax free in any one-year period, *e.g.*, where an IRA owner receives his or her RMD in monthly or quarterly installments, rather than in a single lump-sum payment each year, and
3. the rule prohibiting a non-spouse designated beneficiary from rolling over an amount received under an "inherited" IRA.

It should be noted, however, that the Joint Committee on Taxation's Technical Explanation of new section 401(a)(9)(H) indicates that the relief is aimed at minimum distributions for 2009 that are "otherwise determined by dividing

the account balance by a distribution period."[25] In addition, section 401(a)(9)(H) does not apply to defined benefit plans, and annuity payments under section 401(a)(9) must satisfy the rules in Treas. Reg. section 1.401(a)(9)-6 that apply to distributions from defined benefit plans. Hence, an argument can be made that Congress did not intend for the 2009 RMD relief to apply to annuity payments. If the 2009 RMD relief does not apply to annuity payments, individuals will not be able to roll over their 2009 annuity payments. Also, in the case of an IRA, the issuer presumably must (1) provide the IRA owner with the RMD statement required under Notice 2002-27 no later than Jan. 31, 2009, and (2) check box 11 on the 2008 Form 5498, indicating that an RMD from the IRA is required for 2009.

In this regard, as mentioned above, Notice 2009-9 provides that IRA issuers (1) should not check box 11 of the 2008 Form 5498, and (2) need not provide IRA owners with the statements that otherwise are required under Notice 2002-27 when an RMD is required to be made for a calendar year. Notice 2009-9 does not provide different rules for IRA issuers that make distributions in the form of annuity payments. Perhaps this Notice can be read as indicating that the IRS and the Treasury Department ("Treasury") interpret the 2009 RMD relief as applying to annuity payments. Nevertheless, there is some uncertainty about whether Congress in WRERA, and the IRS and the Treasury in Notice 2009-9, intended for the 2009 RMD relief to apply to annuity payments, or whether the government failed to contemplate the application of the relief to such payments and would have provided different rules for annuity payments if they had addressed the matter.

NEED FOR RELIEF FROM THE 60-DAY ROLLOVER REQUIREMENT

Tax-free rollover treatment only applies to eligible rollover distributions from non-IRA plans, and certain distributions from IRAs, that are rolled over within 60 days.[26] Distributions for 2009 that otherwise could not be rolled over because they are RMDs might qualify for tax-free rollover treatment under the 2009 RMD relief.

Unfortunately, WRERA was not signed into law by President Bush until Dec. 23, 2008, and many individuals receive their annual RMDs early each year. It is possible that the 60-day rollover period will expire for some individuals before they become aware of the 2009 RMD relief, determine whether it applies to them, decide to take advantage of the relief, and actually roll over a distribution. Absent relief, many individuals will be unable to act quickly enough to roll over distributions that qualify for tax-free rollover treatment as a result of the 2009 RMD relief.

Fortunately, the Secretary of the Treasury has statutory authority to waive the 60-day rollover requirement where the failure to waive the requirement would be "against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement."[27] Hence, this issue can be easily resolved through guidance.

IMPACT OF 2009 RMD RELIEF ON CERTAIN ANNUITY BENEFITS

It is possible that the 2009 RMD relief might impact certain annuity benefits that interact with the section 401(a)(9) minimum distribution requirements. For example, a variable deferred annuity contract that is issued as an IRA or section 403(b) contract might offer a guaranteed minimum withdrawal benefit ("GMWB"). A GMWB permits the owner to take withdrawals from the contract for a year up to a guaranteed annual withdrawal amount ("GAWA"), regardless of the amount of the cash value that exists under the contract. If a withdrawal during a year exceeds the GAWA, the GAWA is recalculated and reduced. Generally, the contract will terminate if such an excess withdrawal reduces the cash value of the contract to zero.

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Under some GMWB designs, an RMD that exceeds the GAWA will not be treated as an excess distribution that triggers a recalculation and reduction of the benefit, and the possible termination of the contract. Put differently, a GAWA that is less than the RMD for a year is increased to equal the amount of the RMD. The 2009 RMD relief might result in a reduction in the GAWA in cases in which the GAWA is less than the RMD that would be payable absent the relief. Where the temporary waiver of section 401(a)(9) for 2009 eliminates the RMD for 2009, it also eliminates any excess of the RMD over the GAWA that might have existed absent the waiver, and thus eliminates any increase in the GAWA that otherwise would have occurred absent the waiver.

AMENDING PLANS AND CONTRACTS FOR THE 2009 RMD RELIEF

Section 201(c) of WRERA sets forth special provisions relating to a pension plan or annuity contract that must be amended in order to provide the 2009 RMD relief. In general, if a pension plan or annuity contract needs to be amended to provide this relief, the plan or contract will not fail to be treated as operating in accordance with the terms of the plan where (1) the plan or contract amendment is made on or before the last day of the first plan year beginning on or after Jan. 1, 2011 (or Jan. 1, 2012, in the case of a governmental plan), and (2) during the period beginning on the effective date of the amendment and ending on Dec. 31, 2009, the plan or contract is operated as if the amendment were in effect.

Whether an amendment is necessary will depend on the terms of the arrangement, and will require a review of the plan and/or contract. It is possible that the existing terms of some arrangements are broad enough to be read as permitting the 2009 RMD relief without modification. A plan or contract that incorporates the section 401(a)(9) minimum distribution rules largely by reference, and thus also incorporates the 2009 RMD relief by reference, likely will not need to be amended in order to provide for the relief.

For instance, an issue exists whether it is necessary for an annuity contract that has been approved as to form by the IRS as a prototype IRA contract to be amended in order to provide for the 2009 RMD relief. Absent guidance, such an amendment to a prototype IRA annuity contract would result in loss of prototype status unless the issuer obtains prototype approval of the amended contract from the IRS. Also, if it is determined that an amendment is required, and the amendment is not timely made, IRA annuity contracts that provide the 2009 RMD relief will be treated as failing to operate in accordance with their terms, and presumably as failing to qualify as IRA annuity contracts. Such a failure results in taxation to the IRA owner.

It appears that the better interpretation is that prototype IRA annuity contracts need not be amended in order to provide the 2009 RMD relief. This is because the section 401(a)(9) minimum distribution rules are imposed generally on IRAs under section 408(b)(3) and the regulations thereunder.[28] The model language that the IRS requires to be incorporated into an IRA annuity contract as a condition of granting prototype approval states that notwithstanding any provision of the contract to the contrary, the distribution of the entire interest in the contract must be made in accordance with the applicable requirements of section 408(b)(3) and the regulations thereunder, the provisions of which are incorporated by reference.[29] Accordingly, the 2009 RMD relief under new section 401(a)(9)(H) can be viewed as incorporated by reference into, and thus as provided under, a prototype IRA annuity contract. Hopefully, the IRS will clarify this issue by issuing guidance to this effect.

This interpretation is consistent with the IRS's position in Notice 2005-95.[30] This guidance addressed minor changes to the temporary regulations under section 401(a)(9) that were made in the final regulations under that section. The IRS took the position in Notice 2005-95 that a prototype IRA annuity contract need not be amended merely to reflect these minor changes in order to retain its prototype status.

CONCLUSION

The steps taken by Congress in WRERA to temporarily waive the section 401(a)(9) minimum distribution require-

ments for 2009, and make a related amendment to the tax-free rollover rules under section 402(c), were helpful steps in response to the economic crisis. Indications are that it is doubtful that Congress will enact further RMD relief. It is important to be aware of the limitations of the 2009 RMD relief, and of the impact that the relief might have on certain annuity benefits that interact with the minimum distribution requirements. As discussed above, a number of issues remain about how this 2009 RMD relief operates, *e.g.*, with respect to the application of the relief to amounts that are automatically paid as RMDs each year, amounts under an IRA that are paid as RMDs more frequently than annually, and amounts that are paid as RMDs in the form of annuity payments. Also, if the relief is offered under a plan or contract, it will be necessary to determine whether the plan or contract must be amended in order to provide for the relief. Hopefully, the IRS and the Treasury will issue guidance addressing at least some of these issues.

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END NOTES

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").
2 Pub. L. No. 110-458.
3 2009-5 I.R.B. 419.
4 Section 401(a)(9)(A) and (C).
5 Section 401(a)(9)(B)(i); Treas. Reg. section 1.401(a)(9)-5, Q&A-5(a).
6 Section 401(a)(9)(B)(ii) and (iii); Treas. Reg. section 1.401(a)(9)-5, Q&A-5(b).
7 *See* Treas. Reg. section 1.401(a)(9)-5 and Treas. Reg. section 1.401(a)(9)-6.
8 *See* Treas. Reg. section 1.401(a)(9)-5, Q&A-1(a) and Q&A-3(a).
9 Section 408(d)(3)(C).
10 Treas. Reg. section 1.408-8, Q&A-5.
11 Treas. Reg. section 1.401(a)(9)-8, Q&A-10.
12 2002-1 C.B. 814.
13 Section 401(a)(9)(H)(i); STAFF OF J. COMM. ON TAX'N, 110TH CONG., TECHNICAL EXPLANATION OF H.R. 7327, THE "WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008," AS PASSED BY THE HOUSE ON DECEMBER 10, 2008, at 26 (J. Comm. Print 2008) (the "Joint Tax Committee Explanation").
14 *Id.*
15 Section 401(a)(9)(H)(ii)(I).
16 Joint Tax Committee Explanation at 26-27.
17 Section 401(a)(9)(H)(ii)(II).
18 Joint Tax Committee Explanation at 27.
19 *Id.*
20 *See* sections 401(a)(31), 402(c), 402(e)(6), 403(a)(4), 403(b)(8), 403(b)(10), 408(d)(3), and 457(e)(16).
21 Joint Tax Committee Explanation at 27.
22 Section 408(d)(3)(E).
23 While campaigning for President in October 2008, Barack Obama suggested giving retired individuals the choice of forgoing RMDs or exempting withdrawals up to the RMD amount. *See* Emily Brandon et al., "What Obama and McCain's New Plans Mean for You," *U.S. NEWS & WORLD REPORT*, Oct. 14, 2008, *available at http://www.usnews.com/articles/business/retirement/2008/10/14/what-obama-and-mccains-new-plans-mean-for-you.html.*
24 *See* Treas. Reg. section 1.402(c)-2, Q&A-5; Sections 2.01(a) 2.02(a) of Rev. Rul. 2002-62, 2002-2 CB 710.
25 Joint Tax Committee Explanation at 26.
26 *See* sections 402(c)(3), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16).
27 Section 402(c)(3)(B); section 408(d)(3)(I).
28 *See* Treas. Reg. section 1.408-8, Q&A-1(a).
29 *See* paragraph (15)(a) of the List of Required Modifications and Information Package ("LRMs") for traditional IRA annuity contracts; paragraph (15)(a) of the LRMs for SIMPLE IRA annuity contracts; and paragraph (16)(a) of the LRMs for Roth IRA annuity contracts.
30 2005-2 C.B. 1172.

ACLI UPDATE COLUMN

By William Elwell

ACLI'S CAPITAL & RESERVE RELIEF PROPOSALS

In late 2008, in the midst of what has been described as "an unprecedented time of economic upheaval,"[1] the American Council of Life Insurers (ACLI) made several proposals to the National Association of Insurance Commissioners (NAIC) to provide life insurers the necessary capital flexibility to operate in a highly volatile economic climate. These proposals, many of which have been under consideration by insurance regulators for several years and were expected to be adopted in 2009, related to four categories: (1) life insurance reserves; (2) annuity reserves and risk-based capital; (3) risk-based capital for investments; and (4) accounting for Deferred Tax Assets (DTAs). ACLI had urged NAIC to adopt these proposals in time for them to apply to life insurance companies' year-end 2008 financial reports.

ACLI's proposals, if implemented, would have freed up approximately $25-30 billion in capital that is now trapped due to outdated reserving, accounting and investment standards that ultimately impact risk-based capital requirements. In the current economic environment, these conservative methodologies may actually cause undue stress to the very companies whose financial integrity they were intended to assure. The capital provided through implementation of ACLI's suggested changes was estimated to be 6-7 percent of the industry's total adjusted capital reported for 2007.

NAIC CONSIDERATION OF ACLI'S PROPOSALS

In response to ACLI's request, NAIC created the Capital and Surplus Relief Working Group to review these proposals with the aid of several NAIC technical groups. In December 2008, these technical groups approved six of ACLI's nine proposals, in some cases with modifications that would have reduced the amount of relief afforded by approximately one-half.[2] On Jan. 27, 2009, the NAIC Working Group adopted these recommendations from the technical groups.[3] As has been widely reported, on Jan. 29, 2009, NAIC's Executive Committee and Plenary ultimately rejected expedited action on all these proposals.[4]

DTA PROPOSAL

While ACLI views all these proposals as important, the proposal to modify the accounting for DTAs has the largest potential impact for the life insurance industry. DTAs represent amounts that an insurance company may be able to use to offset future tax liabilities if the insurer ultimately earns a profit in that future period. While the technical nature of the DTA has been discussed previously in an earlier edition of this publication,[5] this update column focuses on the ACLI's DTA proposal and the NAIC's subsequent modifications.

Statutory accounting rules have placed conservative limitations on the amount of a DTA that companies may recognize. In light of the recent unprecedented declines in equity and fixed income investment valuations, the current constraints on the admissibility of DTAs are unnecessarily amplifying the adverse economic effect on insurers. Consequently, ACLI requested that NAIC consider revising the NAIC Statement of Statutory Accounting Principles No. 10—*Income Taxes* (SSAP 10) for realization of DTAs due to the economic crisis and its impact on insurer's surplus.[6]

Currently, SSAP 10 admits gross DTAs in an amount equal to the sum of:

1. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;
2. The lesser of :
   - i. The amount of gross DTAs, after the application of paragraph 1, expected to be realized within one year of the balance sheet date; or
   - ii. 10 percent of statutory capital and surplus; and
3. The amount of gross DTAs, after application of paragraphs 1 and 2, that can be offset against existing gross deferred tax liabilities (DTLs).[7]

These DTA calculation components provide a conservative limitation by restricting the DTA's realization pe-

riod to one year and capping this component amount at 10 percent of adjusted capital and surplus.[8] Generally, if the surplus limitation does not come into play, SSAP 10 allows recognition of net DTAs (gross DTAs net of DTLs) in an amount equal to DTAs that reverse by the end of the subsequent calendar year. This approach employs an unrealistically short time period for allowing an insurance company to utilize a DTA for determining admissibility. Equity market declines and investment write downs under current economic conditions, coupled with statutory reserving and the expensing of acquisition costs, are giving rise to growing amounts of DTAs that companies often will realize more than one year in the future. Utilization of the SSAP 10 formulaic approach for admitting an insurance company's DTAs is far more conservative than the approach to DTA recognition used in US GAAP (SFAS 109) or International Financial Reporting Standards (IFRS).

US GAAP allows full recognition of the entire DTA, but sets up a valuation allowance (or reserve) for any DTA that has a likelihood of 50 percent or better that some portion or all of the DTA will not be realized.[9] The valuation allowance should be sufficient to reduce the DTAs to the amount that is more likely than not to be realized.[10] Aligning DTA admissibility with US GAAP standards provides the industry with the ability to recognize the tax benefit of DTAs that are more likely than not to be realized, while still requiring a reserve threshold that meets the principles of statutory accounting.

ACLI believes that the time period over which an insurance company can realize a DTA for a tax loss or credit carryfoward should be consistent with the federal tax law and not be an unrealistically short period that has no basis under the tax law. Specifically, ACLI requested that NAIC: (1) for 2008, increase the period over which the benefits are projected to be realized from one year to five years and increase the limit as a percent of statutory capital and surplus from 10 percent to 25 percent; and (2) replace the current limits on the admissibility of DTAs under SSAP 10 with a valuation allowance approach similar to US GAAP.[11]

Because of the interdependency between SSAP 10 paragraphs 10a and 10b relating to the reversal of existing temporary differences, ACLI requested that the limits of both 10a and 10b change concurrently, as these two sections were drafted to work in an interdependent manner in the existing version of SSAP 10. These changes included changes to paragraphs 10a, 11a, and 11d.[12] Current paragraph 10a allows admission of gross DTAs to the extent that taxes paid in the carryback period could be recovered by the reversal of those existing temporary differences within the next year.[13] Current paragraph 10b allows admission of gross DTAs in the amount expected to be realized from the reversal of existing temporary differences in the subsequent calendar year, less the amount of gross DTAs admitted under paragraph 10a, but not in excess of 10 percent of adjusted capital and surplus.[14] Determining the realizability of DTAs over a future period also requires the determination of the reversing temporary differences over that same period.[15] To properly preserve this relationship, modification of paragraph 10b(i) requires a similar modification to paragraph 10a to account for reversals of existing temporary differences within the following three years.

NAIC DTA MODIFICATIONS

Based on a recommendation from the NAIC Statutory Accounting Principles Working Group in December 2008, the NAIC Capital and Surplus Relief Working Group recommended increasing the realization limitation period from one year to three years, and revising the percentage of capital surplus limitation from 10 percent of capital and surplus to 15 percent of capital and surplus.[16] The Working Group also recommended that the Statutory Accounting Principles Working Group revisit this issue after the 2009 reporting period to determine if these reduced limitations remain appropriate.[17]

To address concerns about losing regulatory authority over companies that would be subject to any type of regulatory control based on their level of risk-based capital, the Capital and Surplus Relief Working Group further modified the proposal to prohibit the additional increase

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generated by the revised DTA limitations counted in: (1) determining capital or surplus for RBC purposes if the company is below the trend test line; (2) determining the extraordinary dividend threshold; (3) holding company filing triggers; (4) calculation of investment limitations, including the basket clause; (5) liquidation and rehabilitation triggers; and (6) any other regulatory processes and procedures that utilize admitted assets or statutory surplus.[18] The Working Group also included a requirement that insurers separately report the amount of assets or surplus admitted under the increased thresholds by specifically reporting the items as a write-in to where the impact can be transparent to users of the financial statements.[19]

FURTHER CONSIDERATIONS

Because NAIC declined to act, the resulting lack of uniform guidance on how to respond to rapidly changing and volatile economic conditions leaves the responsibility for addressing these concerns to the individual states. Several states have already granted relief to individual domestic companies to implement some of the relief ACLI requested.[20] Additionally, NAIC continues to consider some of the proposals through the NAIC's standard process of debate in technical groups and committees. ACLI expects that the NAIC Statutory Accounting Principles Working Group will continue to review the DTA proposal, so ACLI will continue to work with NAIC and individual states to help them understand how the DTA and other proposals will: (1) provide insurance life companies with a financial cushion and operational flexibility; (2) provide the public with more accurate information on the industry's ability to withstand any further potential downturn in the economy; and (3) give consumers what they need to make informed decisions about their financial futures.

END NOTES

1. *See* Press Release, NAIC, *Capital, Surplus Relief Measures Receive Open, Expeditious Review* (Jan. 5, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_review.htm.*
2. *See* Capital & Surplus Relief Working Group Grid of Information Relative to Each ACLI Request, at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_wg_consensus_rec_grid.pdf.*
3. *See* Press Release, NAIC, *NAIC Holds Hearing to Discuss Capital and Surplus Changes* (Jan. 27, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_hearing.htm.*
4. *See* Press Release, NAIC, *Regulators Deny Industry's Request To Lower Capital, Surplus Standards* (Jan. 29, 2009), at *http://www.naic.org/Releases/2009_docs/capital_surplus_denied.htm.*
5. *See, e.g.*, Edward L. Robbins, "Calculation of Tax Expense in a Principles-Based Reserve Environment," *TAXING TIMES*, Feb. 2008, at 24.
6. *See* letter from Frank Keating (ACLI) to Sandy Praeger (NAIC) (Nov. 11, 2008), at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_acli_proposal.pdf.*
7. *See* NAIC Statement of Statutory Accounting Principles No. 10—*Income Taxes* (SSAP 10), para. 10.b.i (1-year restriction of realization period) and para. 10.b.ii (10% limitation of adjusted capital and surplus).
8. *Id.*
9. Statement of Financial Accounting Standards No. 109 (FAS 109) (Feb. 1992), at *http://fasb.org/pdf/fas109.pdf.*
10. *Id.*
11. *See* Keating letter, supra note 6.
12. *See* Bruce Ferguson & Paul Graham letter to NAIC's Capital and Surplus Relief Working Group (Jan. 23, 2009), at *http://www.naic.org/documents/committees_ex_capital_surplus_relief_exposure_comments_acli.pdf.*
13. *See* SSAP 10, supra note 7.
14. *Id.*
15. *Id.*
16. *See* Report from Thomas Hampton, Chair, Capital and Surplus Relief (EX) Working Group to NAIC Executive Committee, Jan. 28, 2009, at *http://www.naic.org/committees_e_capital_surplus_relief.htm.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *See, e.g.*, Iowa State Insurance Bulletin 09-01, Feb. 3, 2009, at *http://www.iid.state.ia.us/docs/bull0901.pdf* (permitting domicile companies to use higher limitations to determine the admitted amount of DTAs).

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SECTION 988 HEDGING IMPACTED BY ECONOMIC PROBLEMS

By Biruta P. Kelly and Peter H. Winslow

Lending or borrowing in foreign currency subjects a U.S. company to foreign currency risk, which can be reduced or eliminated using a hedge. For tax purposes, the debt instrument and the hedge usually are two separate properties and the usual tax rules that are applicable to the debt instrument and the hedge may result in timing and character mismatches. To eliminate these issues, a company may designate the hedging instrument or instruments and the debt as a section 988 hedging transaction. A section 988 hedging transaction integrates the hedge with the debt instrument to create a synthetic debt instrument denominated in a currency other than the debt's currency. For example, a bond that pays in Euros may be turned into a synthetic U.S. dollar bond when it is integrated with an appropriate pay Euro/receive U.S. dollars swap contract.

The effect of the section 988 hedging transaction is to treat for federal income tax purposes the transactions as if they were a single synthetic debt instrument issued in another currency. This treatment is for the taxpayer that has entered into the transaction and does not affect the tax treatment of any of the other parties to the transactions. In addition to coordinating timing and character, other benefits of a section 988 hedging transaction are that neither the qualifying debt instrument nor the hedge will be subject to the section 1092 straddle rules, the section 1256 mark-to-market rules, or the section 263(g) capitalization rules.

To qualify as a section 988 hedging transaction, the rules of the Treasury regulations[1] must be met, including a requirement that the transaction be identified as a qualified hedging transaction before the close of the day that the hedge is entered into. The synthetic debt instrument will remain in place so long as the qualifying debt and the hedge remain in place.

The current economic crisis has caused problems where section 988 hedging transactions have terminated due to counterparty credit issues and new hedging transactions are substituted. The first consequence is that when the initial hedge is terminated, the taxpayer is considered as "legging out" of the integrated treatment and any gain or loss on all of the positions making up the synthetic debt instrument from the date it was identified as a section 988 hedging transaction to the legging-out date is realized and recognized for tax purposes.[2] Second, the regulations provide that the part of the qualified hedging transaction that has not been terminated can never be part of a qualified hedging transaction for any period after the legging-out date.[3] Thus, the taxpayer cannot identify the qualifying debt instrument and the new hedge as a section 988 hedging transaction and continue receiving integrated treatment. This rule is particularly harsh where the prior integration was with a capital asset. In such case, a replacement hedge may not qualify as a tax hedging transaction under section 1221(b)(2). Therefore, the inability to identify the substituted hedge as part of a new section 988 hedging transaction could cause the straddle rules to come into play with a subsequent deferral of loss recognition.

There appears to be no sound tax policy reason to deny integrated treatment for succeeding hedging transactions at least where the legging-out was by reason of counterparty credit risk exposure. Our understanding is that the IRS National Office has this situation under consideration. A change in the rule prohibiting further integration should not require a change in the regulations because the regulations already provide that the Commissioner may treat transactions as integrated.[4] Thus, guidance could take the form of a ruling or notice, which could be welcome relief if the IRS chooses to address this problem.

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END NOTES

1. Treas. Reg. § 1.988-5(a) provides rules for section 988 hedging transactions relating to debt instruments. Treas. Reg. § 1.988-5(b) provides similar rules for integrating a hedge with an executory contract.
2. Treas. Reg. § 1.988-5(a)(6)(ii).
3. Treas. Reg. § 1.988-5(a)(6)(ii)(D).
4. Treas. Reg. § 1.988-5(a)(8)(iii).

IRS FOREIGN INSURANCE EXCISE TAX – AUDIT TECHNIQUES GUIDE PRESENTS QUESTIONABLE POSITIONS

By Peter H. Winslow and Biruta P. Kelly

Section 4371 imposes an excise tax on a policy of insurance or reinsurance issued by a foreign insurer or reinsurer. The tax is four percent of premiums paid for direct insurance of U.S. property/casualty risks or one percent of premiums paid for a life or accident and health policy or annuity with respect to a U.S. citizen or resident or for reinsurance of U.S. risks. The tax does not apply when the insurer or reinsurer is engaged in a U.S. business and is subject to U.S. income tax. The persons liable for the tax include any person who makes, signs, issues or sells the policy of insurance or reinsurance. Many tax treaties with foreign countries contain provisions that eliminate the excise tax liability under certain circumstances.

In October 2008, the Internal Revenue Service (IRS) added to its Web site a guide for IRS agents to follow when auditing foreign insurance excise tax liability. An introduction to the guide cautions that it is not an official pronouncement of the law or of the IRS's position, but it undoubtedly reflects input from the IRS personnel who administer the excise tax and audit compliance.

The guide is detailed, containing 12 chapters. Chapter 7 contains an extensive discussion of the controversial cascading excise tax issue. In Rev. Rul. 2008-15,[1] the IRS set forth its position that the excise tax can apply to the same risks more than once—once to insurance (or reinsurance from a U. S. insurer) of U.S. risks by a foreign insurer, and again if the foreign insurer reinsures the risks with another foreign reinsurer. According to the IRS, this conclusion applies whether or not the foreign reinsurance treaty has a nexus with the United States other than the fact that the reinsured risks found their origin in the United States. In Announcement 2008-18,[2] the IRS set forth a voluntary compliance program which, when followed, provides excise tax audit protection for premiums paid before Oct. 1, 2008. Major insurance trade associations jointly submitted comments on Rev. Rul. 2008-15, explaining several legal and practical reasons why the IRS's cascading excise tax theory is suspect.[3] Undoubtedly, the issue will be litigated if the IRS declines to withdraw the ruling.

The portion of the audit guide added to the IRS Web site on the cascading excise tax issue does not break new ground beyond what has been stated in prior IRS pronouncements. The same cannot be said for the discussion in Chapter 4 of the timing of "premium paid," on which the excise tax is based. The audit guide says:

> **Cash vs. Accrual Method of Accounting**
> In determining when premiums are paid, and thus subject to the tax, the accrual method of accounting, not the cash-basis method of accounting applies. Revenue Ruling 77-453, 1977-2 C.B. 237, and G.C.M. 37, 201 (July 26, 1977) support an interpretation of the term "amounts paid for reinsurance" under I.R.C. § 832(b)(4) as including amounts accrued as well as amounts actually paid. Ceded premiums are considered paid to the reinsurer when all events have occurred that fix the reinsurer's right to the premiums and the amount of such premiums is reasonably ascertainable.

The guide's position that an accrual method of accounting applies to the excise tax is in apparent conflict with the statute which refers to "premium paid"—a cash concept. The regulations confirm this by stating that the excise tax attaches "at the time the premium payment is transferred to the foreign insurer or reinsurer."[4]

That the excise tax attaches only to actual payments of premiums, rather than on accrued premiums, also is supported by the legislative history. Prior to amendment by the Excise Tax Reduction Act of 1965,[5] section 4371 imposed the tax with respect to "the premiums charged on the policy of reinsurance." Section 804 of the 1965 Act provided for

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the payment of the tax by return and added a sentence to the statute to make it clear that the excise tax would no longer be based on premiums charged.

The audit guide cites authorities which, it says, hold that "premiums paid on reinsurance" in the context of determining underwriting income under section 832(b)(4) for property/casualty insurers is based on an accrual method of accounting.[6] However, this analogy to the income tax accounting rules under section 832 is no more relevant than the many other tax provisions where the term "paid" or "payment" refers to a cash method of accounting.[7]

This cash vs. accrual accounting issue has arisen in IRS audits most frequently in the context of funds withheld reinsurance. In this type of indemnity reinsurance, instead of paying a portion of the gross premium to the reinsurer, the ceding company withholds the funds and makes a promise to pay the reinsurer's share of profits in the future. If experience is adverse, the reinsurer reimburses the ceding company. If the experience is favorable, the ceding company pays a fee to the reinsurer to compensate for its assumption of risk. Taxpayers have taken the position that the excise tax attaches only when actual payments are made to the reinsurer in funds withheld reinsurance, pointing out the basic tax principle that a mere promise to pay does not constitute a payment, even if such promise is evidenced by a written agreement.[8] In support of its position, the IRS relies on rulings and case law that suggest that the term "premium paid" is measured by gross amounts due to the reinsurer and is not reduced by obligations to the ceding company that are netted against the premiums otherwise due the reinsurer.[9] But, under the tax law, when an actual netting occurs a payment has been constructively made. Thus, the netting principle does not depart from a cash concept for implementing the excise tax and does not support an accrual accounting for determining the timing of premiums paid.

The problem with the audit guide analysis is that it fails to appreciate the fundamental difference between an excise tax that is imposed on the manufacture, use or sale of a commodity (in this case an insurance policy) and an income tax. An excise tax typically is imposed on an event or a thing. The proper inquiry is to determine when the excise tax attaches and the measurement of the tax at that point in time. Methods of accounting for determining taxable income over a multi-year period have little relevance.

This brings us back to the cascading excise tax. Here again, the IRS may be overreaching perhaps because it interprets Code provisions that impose an excise tax using income tax notions. With respect to the income tax, the United States taxes its citizens on worldwide income and the applicable Code provisions presume that all income from whatever source is taxable. By contrast, an excise tax, by definition, is imposed on a transaction within the jurisdiction of the taxing authority. In Rev. Rul. 2008-15 the IRS seems to be forgetting this basic principle in its attempt to impose an excise tax on a foreign transaction.

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END NOTES

1. 2008-12 I.R.B. 633.
2. 2008-12 I.R.B. 667.
3. Letter of Brenda Viehe-Naess, Washington Advocates Group, dated July 9, 2008.
4. Treas. Reg. § 46.4374-1(b).
5. Pub. L. 89-44, 89th Cong., 1st Sess. (1965).
6. It is questionable whether the IRS would continue to contend that the accrual method of accounting always applies under section 832 for premiums paid on reinsurance in light of its departure from the accrual method for at least some gross premiums written in Treas. Reg. § 1.832-4.
7. *E.g.*, Treas. Reg. § 1.461-4(g)(1)(ii)(A); Treas. Reg. § 1.404(a)-1(c); Treas. Reg. § 31.3402(a)-1(b).
8. *See, e.g., Helvering v. Price*, 309 U.S. 409 (1940); *Foley v. Commissioner*, T.C. Memo. 1976-60; Rev. Rul. 76-135, 1976-1 C.B. 114.
9. Rev. Rul. 79-138, 1979-1 C.B. 359.

APPEALS COURT AFFIRMS TEXTRON (OR NOT)

By Samuel A. Mitchell and Peter H. Winslow

In what some characterized as a significant taxpayer victory, the First Circuit Court of Appeals initially upheld a lower court ruling that Textron Inc.'s tax accrual workpapers are subject to protection under the work product

doctrine.[1] Under that doctrine, documents that are prepared in anticipation of litigation are protected from disclosure unless the party seeking the documents can demonstrate a compelling need for the materials and cannot obtain the information any other way. The doctrine is designed to enhance an attorney's ability to represent clients without fear that an opponent in current or anticipated litigation will use the work product to the disadvantage of the attorney's client. Typically, the important sticking points for parties claiming work product protection are whether the documents were prepared in anticipation of litigation and whether the client has waived the protection by disclosing the work product to a potentially adverse third party.[2]

On March 25, 2009, the First Circuit vacated the ruling and scheduled an *en banc* hearing for June 2, 2009.

On appeal, the IRS argues that the tax accrual workpapers were not prepared in anticipation of litigation because tax disputes with the IRS are not "litigation," and because Textron had a business purpose related to financial reporting that was not related to litigation. In its vacated opinion, the Appeals Court panel rejected both of these arguments, holding that not all "dealing with the IRS during an audit is 'litigation'," but that resolutions of disputes through the adversary administrative process, including administrative appeals, meets the definition of litigation. The panel's reference to the IRS Appeals process as an adversarial process is not how IRS Appeals Officers typically view their role. Most Appeals Officers attempt to provide an independent review of the IRS's proposed adjustments seeking what they perceive to be a fair resolution based on an evaluation of the litigating hazards. Nevertheless, the Appeals process can be viewed as adversarial because the IRS Exam team is provided an opportunity to make its case prior to the commencement of the taxpayer/Appeals settlement negotiation.

Regarding the second IRS argument, the panel held that Textron prepared the tax accrual workpapers "because of" litigation, in spite of the fact that the taxpayer had other business reasons (*e.g.*, financial reporting) for preparing the documents. According to the panel, there would be no reason for the financial reporting "but for" the prospect of litigation. The panel held that the documents, because they were designed to assist the taxpayer to establish financial reporting reserves taking into account the risk of tax litigation with the IRS, would not have been prepared "but for" the prospect of litigation.

The panel also dealt with the waiver issue. The work product doctrine is designed with fundamental fairness in mind; it is unfair for an opponent in litigation to take advantage of its adversary's preparation for the litigation. With this in mind, courts have recognized that the protection is waived if the party that created the work product discloses it to a party which is in an adversarial position. Here, Textron disclosed its tax accrual workpapers to its independent auditors, with the stipulation that the auditors had to return the documents to Textron. On appeal, the IRS recognizes that Textron and its auditors were not adversaries, but argues that the auditors may be a potential adversary or at least a "conduit" to a potential adversary. The panel rejected the notion that the auditors were potential adversaries, but nevertheless ordered a remand of the issue to the district court to determine whether the auditors were, in effect, a conduit to a potential adversary. Specifically, the panel recognized

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that a disclosure to a non-adversary that significantly increases the risk of disclosure to an adversary or potential adversary can result in a waiver. The panel recognized that the auditing firm used the Textron workpapers to create its own workpapers analyzing Textron's tax reserves. Because the auditor's workpapers may be discoverable by the IRS through a third-party summons, the panel recognized that the auditor's workpapers may disclose Textron's tax analysis. If this were the case, the disclosure to the auditor could be considered a waiver because it resulted in a substantial risk of disclosure to an adversary, the IRS, albeit indirectly.

Tax department's celebration of the *Textron* decision was premature. There is a possibility that the full court in its *en banc* review will find that the auditor's workpapers are discoverable and that they reveal Textron's thoughts and analysis from its own workpapers, even though those workpapers were only shown to the auditor and not retained by the auditor. If this is the case, the full Court of Appeals could find that a waiver occurred and the IRS could obtain the documents. Thus, taxpayers may not be able to prevent disclosure by simply requiring that the auditors not copy the tax accrual workpapers. The waiver issue, presumably, will turn on the level of detail in the auditor's workpapers. More fundamentally, the full court could rethink the entire reasoning of the panel's original position and hold that the panel misapplied the "because of" litigation test.

A key fact in the Textron case is that the IRS was seeking Textron's internal workpapers. The reasoning of the panel indicates that it may not have been troubled if the IRS sought discovery of the outside auditor's workpapers. In a FIN 48 context, where taxpayers are required to do a more rigorous tax provision analysis and a more robust disclosure, we would expect the outside auditors' workpapers underlying tax positions to contain significantly more detail than the auditor's workpapers from pre-FIN 48 years, such as those in Textron. Therefore, regardless of the outcome, the opinion may not apply in a FIN 48 environment.

As noted in our May 2008 article, however, the standard for FIN 48 disclosure turns on what would occur regarding an issue in litigation (*i.e.*, is it more likely than not that the taxpayer would prevail in litigation). Therefore, it could be argued that all FIN 48 workpapers are attorney work product because anticipation of litigation is an integral part of the recognition process. For this reason, the waiver issue and the disclosure of outside auditors' workpapers probably will be the primary focus of FIN 48 workpaper disputes.

As of now, the IRS has not changed its policy of restraint regarding tax accrual workpapers, except when the taxpayer has engaged in tax shelters. This disclosure issue will become much more important if the IRS ever changes its policy.

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END NOTES

1. *United States v. Textron*, No. 07-2361 (1st Cir. Jan. 21, 2009).
2. We discussed this doctrine and its requirements in the May 2008 issue of *TAXING TIMES. See* "What Does Textron Mean for Preserving the Confidentiality of Tax Accrual Workpapers?", Vol. 4, Issue 2 at 20 (May 2008).

REMIC IMPAIRMENTS MAY QUALIFY AS WORTHLESS BAD DEBTS

By Samuel A. Mitchell and Peter H. Winslow

In the September 2008 issue of *TAXING TIMES* we discussed the general tax rules that apply to write-downs of impaired investment assets.[1] In the prior article, we explained the different tax treatment for instruments treated as securities versus other debt instruments. In summary, "securities" are not eligible for a worthlessness deduction until the security is wholly worthless, and the worthlessness deduction is capital in character. A "security" is defined as a stock, subscription right or bond, debenture, note or certificate or other evidence of indebtedness with interest coupons or in registered form issued by a corporation, government or a political subdivision thereof.[2] Classification of an invest-

ment asset as a security is a double disadvantage, in that it delays the timing of the deduction and, in some instances, may limit the ability to realize any benefit because capital losses can be used only against capital gains and the carry-over of capital losses is limited to five years. In the current economic environment, there is no certainty that capital gains will be available to offset capital losses. For these reasons, non-security treatment is preferable because the instruments potentially are eligible for partial bad debt deductions as the instruments become worthless and the deductions are ordinary in character, meaning they can be used to offset ordinary operating income and can be carried forward for a longer period of time.[3]

The issues discussed in our prior article have come up frequently with respect to impairments of investments in Real Estate Mortgage Investment Conduits ("REMICs"). A regular interest in a REMIC entitles the certificate holder to a portion of the cash flows from underlying residential mortgages packaged as securities by financial institutions. Regular interest REMICs along with other asset types have experienced dramatic declines in value as the result of the mortgage crisis and insurance companies have recorded impairments for statutory accounting purposes. Many taxpayers assume that the contingent nature of the cash flows from REMIC regular interests suggests that they would be classified as securities and ineligible for bad debt treatment. However, for federal income tax purposes, REMIC regular interests are treated as debt instruments under section 860B of the Internal Revenue Code.[4] Importantly, moreover, they typically are issued by a trust rather than a corporation or government entity. This means that REMIC regular interests should not be treated as "securities" for purposes of the bad debt rules.[5] Thus, statutory impairments of REMIC regular interests potentially may be eligible for a partial bad debt deduction under section 166 of the Code if the impairment satisfies the partial worthlessness standard for tax purposes. Taxpayers may be able to demonstrate that an impairment, or at least a portion of the impairment, represents a wholly worthless portion of the instrument under the tax standard (*i.e.*, that collection of that portion is hopeless).[6] To the extent the amount of partial worthlessness of a REMIC regular interest is difficult to prove, insurance companies may want to contend that the conclusive presumption of worthlessness under Treas. Reg. § 1.166-2(d) applies. For a company to take advantage of the presumption, its state regulators would need to provide a letter verifying that the impairment was required.

This issue will become increasingly important in tax year 2009, when Statement of Statutory Accounting Principles (SSAP) 98 is adopted. SSAP 98 amends SSAP 43, essentially requiring statutory impairments for structured securities similar to the GAAP impairments.[7] As the impairments become more common, it will be important for companies to be able to evaluate each impairment to determine the portion that satisfies the tax standard of worthlessness and, moreover, to keep in contact with their state regulators in the annual statement examination process if reliance on the conclusive presumption is contemplated.

END NOTES

1. "Tax Aspects of Nonperforming Assets," *TAXING TIMES*, Vol. 4, Issue 3 at 28 (Sept. 2008).
2. I.R.C. § 165(g).
3. Non-life insurance companies can carry Net Operating Losses back two years and forward 20 years. I.R.C. § 172(b)(1)(A)(i)-(ii). Life insurance companies can carry their operations losses back three years and forward 15 years. I.R.C. § 810(b)(1)(A)-(B).
4. Residual Interests, on the other hand, essentially are the equity interests in the REMIC and are not treated as debt. *See* I.R.C. § 860C.
5. A debt instrument must be issued by a corporation or government in order to qualify a security for purposes of a worthlessness deduction under I.R.C. § 165(g)(2)(C). See Treas. Reg. § 1.165-5(a). Commentators agree that regular interest REMICs are not securities. *See, e.g.*, James A. Peaslee, *The Federal Income Taxation of Mortgage-Backed Securities at 270 n.* 147, Probus Publishing (1994).
6. *See TAXING TIMES, supra* note 1.
7. The SSAP requires an impairment to reflect the discounted value of expected future cash flows if that amount is less than book value.

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THE CHARACTERIZATION OF CREDIT DEFAULT SWAPS IS UNDER REVIEW BY NEW YORK INSURANCE REGULATORS AND THE IRS

By Emanuel Burstein

New York's insurance department concluded in September 2008 that "covered" credit default swaps (CDSs), defined here, are insurance contracts under New York Insurance Law. The insurance department's interest in the characterization and regulation of CDSs stems from huge losses realized by CDS sellers from sudden and substantial increases in their CDS obligations, which are a significant source of the current financial problems facing the economy.[1] A CDS arrangement that qualifies as insurance under state law does not necessarily qualify as insurance under the federal income tax, however. Commentators conclude that few, if any, CDS arrangements are insurance under the federal income tax.

Credit Default Swaps

The IRS stated in Notice 2004-52[2] that:

> A credit default swap (CDS) generally refers to a contractual arrangement in which one party (the protection buyer) buys from a counterparty (the protection seller) protection against default by a particular obligor (the reference entity) with respect to a particular obligation (the reference obligation). Typically the protection buyer either pays a single lump sum, or it pays periodical regular fees either until a defined credit event occurs or until the maturity of the CDS if no credit event occurs. Following the occurrence of a credit event, the protection seller typically either pays the protection buyer an amount reflecting the reference obligation's loss in value from the date the CDS was established or purchases from the protection buyer at a pre-determined price an obligation (the deliverable obligation) that is expected to approximate the post-credit-event value of the reference obligation.[3]

A "covered" CDS is a CDS that offsets much or all of the risk of loss from default by a bond issuer or borrower on a bond or loan that the CDS owner holds. Speculators that do not hold related bonds or loans purchase "naked" CDSs to gain from expected increases in their value.

When Are Credit Default Swaps Insurance Under New York Insurance Law?

Section 1101(a)(1) of the New York Insurance law defines an insurance contract as:

> any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.[4]

In his statement for a Congressional hearing on the role of credit derivatives in the U.S. economy, New York Insurance Superintendent Dinallo indicated that in September 2008 the New York insurance department concluded that covered CDSs qualify as insurance under New York State Insurance Law. Superintendent Dinallo reasoned that:

> the covered swap, is insurance. The essence of an insurance contract is that the buyer has to have a material interest in the asset or obligation that is the subject of the contract. . . . With insurance, the buyer only has a claim after actually suffering a loss. With the covered swaps, if the issuer of a bond defaults, then the owner of the bond has suffered a loss and the swap provides some recovery for that loss.[5]

Federal Income Tax Treatment

The IRS and tax professionals are examining the tax characterization of CDS arrangements. The federal income tax applies standards to determine whether a contract qualifies as insurance that differ from those that apply under New York's insurance law. An insurance transaction must involve both risk transfer and risk distribution and satisfy other requirements to qualify as insurance for federal tax purposes. New York Insurance Law section 1101(a)(1) does not require an entity that assumes an insurance risk to distribute it with risks from others for the transaction to qualify as an insurance contract, for example.

The characterization of CDSs under the federal income tax is uncertain. The IRS states in Notice 2004-52 that "some possible analogies for a CDS include a derivative financial instrument such as a contingent option or notional principal contract, a financial guarantee or standby letter of credit and an insurance contract," presumably financial guaranty insurance.[6]

The IRS indicated that to determine whether a CDS contract qualifies as insurance, some commentators scrutinize whether the CDS satisfies traditional factors, such as whether it involves the shifting and distribution of insurance risks. It states, for example, "[s]ome commentators have distinguished CDSs from insurance on the basis that . . . no actual loss need be sustained in order to give rise to an obligation under a CDS[.]"[7] In addition, commentators argue that CDS protection buyers cannot know "how its counterparty manages risk with respect to a particular CDS;"[8] that is, it cannot know if the CDS counterparty distributes the risk in order to determine whether the arrangement involves insurance.

One commentator also concludes that CDS transactions generally do not qualify as insurance for tax purposes but applies an alternative approach to characterize a CDS. Edward Kleinbard, in an article that predates the IRS

Notice, recommends a "functional approach that considers the credit protection seller's risk management strategy as well as the formal terms of the contract in question"[9] in place of the "normative" approach applied by others to determine whether a CDS qualifies as insurance. He argues, in part, that the contention that a CDS does not require the CDS buyer to suffer a loss "is not factually satisfying when applied to the normal case of a protection buyer that in fact is obtaining practical indemnification through that contract."[10] Commentators' arguments distort the intent of the risk shifting test, which is to distinguish insurance from "synthetic investment contacts" such as the arrangement in *Le Gierse*[11] or from self insurance reserves.

Kleinbard's functional approach also diminishes commentators' concerns that CDS participants cannot discern whether its counterparty distributes assumed risks. An element of his approach is a presumption that "in the world of financial services firms, what can be hedged at reasonable cost, is hedged, because market hedging generally is more efficient than relying on the law of large numbers."[12] Kleinbard concludes that CDSs generally are not insurance contracts. His understanding is that CDS counterparties generally use market hedging to manage default risks.[13]

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Convergence of Insurance and Other Financial Products

Many CDS arrangements provide risk management benefits that are similar to benefits provided by insurance contracts, such as financial guaranty coverage, but involve different federal tax treatment of the CDS holders and insurance purchasers. In addition, different tax treatment applies to CDS counterparties and financial guaranty insurers. Differences in the tax treatment of contracts that provide similar risk management benefits can influence one's decision to use a given product, and therefore raise important tax neutrality concerns. This issue has been getting increasingly more important as insurance and other risk management markets have tended to converge in recent years.[14]

CONCLUSION

The New York State Insurance Department concludes that covered CDSs qualify as insurance contracts under New York's insurance law. CDSs that qualify as insurance under state law do not necessarily qualify as insurance under the federal income tax. Commentators conclude that few, if any, CDS arrangements qualify as insurance for tax purposes. Tax-based distortions can arise when insurance, such as financial guaranty coverage, and other financial products, such as CDSs, that address similar risk management goals are subject to different tax rules.

END NOTES

1. House Committee on Agriculture, Hearing to review the role of credit derivatives in the U.S. economy at 5 (November 2008) (Statement of New York Insurance Superintendent Eric Dinallo) (Retrieved from *http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf* on February 2, 2009). [Hereinafter cited as statement of Superintendent Dinallo.] The value of a CDS issuer's obligation is marked to market so that a very significant number of default events in a short time period can result in significant losses. This can trigger sizeable collateral calls and force issuers with limited liquid assets to sell other assets, also at a loss, and further weaken the issuer's financial condition. Dinallo indicated that a ratings downgrade of AIG in September 2008 resulted in immediate collateral calls, for which AIG did not have enough liquid assets.
2. 2004-32 I.R.B. 168 (Aug. 9, 2004). [Hereinafter cited as *Service Notice on CDSs.*] In this Notice, the Service requests information on the tax treatment of credit default swaps.
3. *Id.*
4. New York Insurance Law section 1101(a)(1)(McKinney 2009).
5. *Statement of Superintendent Dinallo*, at 3.
6. *Service Notice on CDSs* at 168.
7. *Id.* at 169.
8. *Id.* But *see* a "functional" approach that can address this concern at note 12 and accompanying text.
9. E. Kleinbard, "Competitive Convergence in the Financial Services Markets," 81 *Taxes-The Tax Magazine* 225, 248 (vol. 81 #3). [Hereinafter cited as *Convergence of Financial Markets Article*]
10. *Id.* at 247.
11. 312 U.S. 53 (1941).
12. *Convergence of Financial Markets Article* at 248.
13. *Id.* at 245 and 249.
14. *See, Convergence of Financial Markets Article*, D. Miller, "Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace," 55 Tax Lawyer 481 (Winter 2002): E. Burstein, *Federal Income Taxation of Insurance Companies* (2nd edition), at 5 (2007).

POINT OF INTEREST

We want to make our Taxation Members aware of a recent article that appeared in the March 2009 Issue of the newsletter Risk Management of the Joint Risk Management Section.

John Manistre's article, "An ERM Approach to Income Tax Risk," explores ERM issues and the impact of income tax on a fair value accounting system. The tax issues raised in this article should be of interest to our members.

Check it out at *www.soa.org* under the Joint Risk Management newsletter Web page.

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