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Uncertainty Remains in Tax Reserve Assumptions for Guaranteed Renewable and Noncancellable Health Insurance

By Edward L. Robbins and Peter H. Winslow

At the time the 1984 Tax Act was developed, efforts were made to conform tax reserves to the statutory reserve environment at the time. The drafters of the Act seemingly presumed that the National Association of Insurance Commissioners (NAIC) and state law always would provide for deterministic minimum reserves computed using defined tables and discount rates. Since then, statutory reserve regulation has undergone substantial changes prompted by product innovation and technological advances, whereas section 807,[1] which deals with deductible tax reserves, has remained relatively unchanged. Consequently, it has become increasingly more difficult to fit statutory guidance (most recently Actuarial Guideline 43)[2] and new product forms into the Code's tax reserve regime. Principle-based reserves likely will exacerbate this problem.

With all the activity surrounding reserving changes for life insurance and variable annuities, tax reserve issues relating to guaranteed renewable and noncancellable health insurance sometimes are overlooked. Certain reserves in these product lines are treated as "life insurance reserves" and thus subject to recomputation for tax purposes under section 807. Actuaries have been struggling for years to fit these reserves into the rules of that Code section.

By its nature, the health insurance product lines contain enormous variations in benefits, and even within one product line, significant differences in benefit terms arise. Thus, standard tables do not function as effectively for health insurance as for life insurance. This additionally complicates the application of the provision for adjustment "as appropriate

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FROM THE EDITOR
DIFFERENT VIEWPOINTS INCREASE UNDERSTANDING

By Brian G. King

Welcome readers. It's hard to believe that we are approaching the final quarter of 2010. It seems like the year just began. This September issue of *Taxing Times* marks the last in our 2010 publication schedule. However, even though this is our last planned issue, we strive to provide up-to-date content on matters affecting the taxation of life insurance companies and products.

With that in mind, it is important to remember that there are a number of tax-related initiatives listed on the IRS Priority Business Plan for 2010 targeting product tax issues. These issues were introduced in a highlight box in the William Wilkins interview featured in our February 2010 issue of *Taxing Times*. While guidance has already been issued on some of the items listed on the 2010 Priority Business plan (*e.g.,* Notice 2010-29 providing guidance on AG43), we expect to see additional guidance issued this year, possibly by the time this issue reaches our readers. Issues still awaiting guidance, targeting product tax, include: a final regulation on the exchange of property for an annuity contract; guidance on the tax treatment of a partial exchange or partial annuitization of an annuity contract; guidance on the treatment of age 100 maturity under §7702 based on Notice 2009-47 comments; and guidance on annuity contracts with long-term care insurance features under §§72 and 7702B. As this guidance is released, we will report on it in a timely fashion.

Providing our readers with accurate and timely information on tax topics is one of our key objectives for our newsletter. It is important to note that our articles go through an extensive peer review process before they are approved for publication. This process was established to preserve the quality and integrity of our newsletter. That being said, given the nature of the topics addressed in *Taxing Times*, content often provides a multitude of opinions. In fact, during the peer review process for this current issue, several articles elicited differing opinions among our reviewers and the authors. These differing opinions generated spirited discussions which proved productive, and provided the authors with the opportunity to reexamine and reflect on their opinions.

Ultimately, the articles as published reflect the opinions of the authors, and we recognize that our readers may not agree with everything that they read in our newsletter. For that reason we encourage differing opinions in the form of counter articles or letters to the editor. Healthy debate and the presentation of differing viewpoints will provide our members with a better understanding of the tax issues impacting our industry. Feel free to contact me directly to discuss ideas for articles. Your contributions will ensure that your voice is heard.

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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FROM THE CHAIR

PROUD OF OUR PROCESS

By Christian DesRochers

This issue of *Taxing Times* is the last issue of 2010, and my last column as chair of the Taxation Section. It has been an enjoyable experience, and I am most appreciative of the dedicated group of volunteers who have helped the section achieve the highest level of member satisfaction of any of the SOA sections, according to the 2009 Member and Candidate Survey. As a section, we are just approaching our 6th anniversary, and we have accomplished a great deal since we began in October 2004. The Section Council began the year with several goals, many of which we have made progress on during the year. These include:

- **Actively Participating in SOA Meetings and Seminars** We have been a sponsor or co-sponsor of sessions at several meetings, including the Life and Annuity Symposium, the Product Tax Seminar, the Valuation Actuary Symposium and the SOA Annual Meeting. We are sponsoring a section breakfast at the Valuation Actuary Symposium this year, the first section to do so, where Craig Pichette will talk about tax aspects of IFRS. We are planning a Tax Reserve Seminar in March 2011, so we hope that you can join us in Orlando for spring break.

- **Developing Webinar Programs —** In April, we sponsored a very successful webinar on Notice 2010-29. We have also conducted two webcasts on product taxation under sections 7702 and 7702A, replacing the boot camp that was previously held as a part of the Product Tax Seminar. We have also agreed to co-sponsor a webinar with the ABA Insurance Tax Committee. Webinars allow us to provide relevant content to a wider audience than in-person meetings, and we anticipate developing a few new webinars in 2011.

- **Encouraging Participation of Treasury and IRS Representatives in Our Programs —** Both the Treasury and the IRS have participated in our programs in the past, especially in the Product Tax Seminar. This year, Sheryl Flum from the IRS and Mark Smith from Treasury also participated in the Life and Annuity Symposium and are scheduled to speak at the SOA Annual Meeting. By encouraging communication between the industry and the government, the section has, I believe, helped both sides better understand emerging issues related to product and company tax.

- **Continuing to Maintain *TAXING TIMES* as a "Must Read" for Insurance Taxation Issues —** *Taxing Times* continues to be recognized as an important publication for life insurance taxation, addressing important and emerging issues from the perspective of tax practitioners. This year, the Editorial Board was expanded to bring additional insight and review to the content.

- **Conducting Surveys of Members on Various Topics of Interest —** This year, we conducted surveys on the role of the tax actuary as well as the recognition of tax in modeling for asset adequacy analysis and risk-based capital. These are scheduled to be discussed at the upcoming SOA Annual Meeting.

- **Encouraging Members to Participate in Section Activities —** We have been looking for ways to increase member participation in section activities. We always welcome articles from new authors for *Taxing Times*, as well as speakers for the various meetings that we sponsor.

- **Reaching Out to Affiliate Members —** As one of the few sections with affiliate members, it has been a challenge to find a workable process by which affiliate members can easily pay dues and maintain their membership. We are working to make affiliate membership a better experience overall.

- **Supporting Research Activities related to Insurance Taxation —** Last year, the section sponsored a mono-

graph on Deferred Taxes authored by Ed Robbins. We are always seeking research ideas to support, and would invite anyone who would like to develop some tax-related research to reach out to the section.

As a section, we have an ambitious agenda supported by a dedicated group of volunteers who willingly commit their time. I want to thank everyone who has helped make this a successful year, and I am confident that as a section we will continue to achieve the highest satisfaction ratings for many years to come. We have a great group of friends of the section, so that our council calls are always interesting. They also provide a great deal of continuity from year-to-year.

I want to particularly thank Christine Del Vaglio, who has done as much as anyone to keep the section moving forward, and making my year as chairman both productive and enjoyable. I also want to thank Meg Weber and Christy Cook, SOA staff liaisons, who have worked hard to make us as successful as we have been in the last year. ◀

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to reflect the risk."[3] Further, there is the matter of rapid table obsolescence in several health product lines, which undoubtedly caused the Treasury Department (Treasury), in its crafting of Treas. Reg. § 1.807-1 (described below), to prescribe the morbidity table for tax purposes in most health product lines. Interestingly, Treasury in its regulation, apparently acknowledging the difficulty in prescribing specific tables for health insurance, in most instances simply prescribes the table used for statutory annual statement purposes.

Another complication for health insurance is that there are potentially four reserve categories in the statutory reserve environment, each with its particular statutory rules for conversion to tax basis reserves:

- Premium reserves (Annual Statement "Unearned premium reserves," Exhibit 6)
- Contract reserves (Annual Statement "Additional reserves," Exhibit 6)
- Claim reserves (located in Annual Statement Exhibit 6)
- Claim liabilities (located in Annual Statement Exhibit 8, Part 1)

It is not always easy to determine whether an annually renewable contract falls within the requisite category of guaranteed renewable or noncancellable. Model Regulations adopted by the NAIC define a guaranteed renewable policy as one that has the right to continue in force by the timely payment of premiums until at least the later of:

- Age 50, or
- Five years from its date of issue

and, during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force. Under those Model Regulations, the insurer's right to make changes in premium rates by class does not eliminate the contract from guaranteed renewable treatment.

It is not always easy to determine whether an annually renewable contract falls within the requisite category of guaranteed renewable or noncancellable.

Treasury Regulations contain a similar definition, but include subtle and potentially important differences: "The term 'guaranteed renewable life, health, and accident insurance policy' means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved . ..." These definitional differences have led to uncertainty, with the Internal Revenue Service (IRS) sometimes concluding that policies that are guaranteed renewable under state law fail to qualify as such for tax purposes. For example, in a private letter ruling,[4] the IRS ruled that a health insurance policy was not guaranteed renewable for tax purposes because the insurer retained the right to cancel the contracts on a state-by-state basis—a right typically retained by the insurer but nevertheless treated as if it were a guaranteed renewable policy for regulatory purposes.

Apart from basic contract-qualification matters, the tax problems that arise for actuaries dealing with contract and claim reserves[5] usually fall into four types of issues: 1) what is the "issue date" for tax reserving purposes; 2) what is the appropriate morbidity table that should be used under section 807(d); 3) when can the table be "adjusted as appropriate to reflect the risks" under section 807(d)(2)(C; and 4) when does a modification to reserve assumptions rise to the status of a change in basis of computing reserves subject to the ten-year spread rule of section 807(f)?

WHAT IS THE ISSUE DATE FOR PURPOSES OF SECTION 807(d)?

An answer to this question is far from certain in the case of claim reserves that qualify as life insurance reserves under health insurance contracts. Under section 807(d), the applicable tables, prevailing statutory assumed interest rates (PSAIRs), and applicable federal interest rates (AFIRs) are all "issue-year driven." That is, the issue year of the contract determines the table and corresponding interest rate for tax reserve valuation. In the case of tax basis health claim reserves, however, most companies have adopted the claim incurral date as the deemed issue date for tax reserve purposes, which makes the most sense from an economic perspective. This practice may appear to be inconsistent with the Code requirement to use the table and interest rate that were applicable when the contract was originally issued. But, there are at least two legal arguments for using the claim incurral date as the deemed issue date.

First, Congress may have intended that the determination of when a contract is considered issued be made in a manner

consistent with the industry's statutory reserving practices. As in section 807(d), the Standard Valuation Law prescribes minimum reserves computed using the interest rate and table applicable as of the time a contract is "issued." In the case of health insurance claim reserves, NAIC guidance specifies that the appropriate discount rate and table are determined at the time the claim is incurred and the claim reserve is first established.[6] Thus, for reserve purposes the NAIC appears to treat the basic contract as matured when a claim is incurred with a new issue date for the contract liability to which the claim reserve relates. Because section 807(d)(4) uses a term of art directly borrowed from the Standard Valuation Law—the year in which the contract was "issued"—Congress can be presumed to have intended that the NAIC's interpretation of the issue date should be followed in computing reserves.

The second argument is that the determination of the issue date for reserve purposes is just one of many assumptions that is part of the reserve methodology. Because section 807(d) defers to the NAIC reserve method for computing tax reserves, the NAIC's requirement as to the issue date for health claim reserves should be followed for tax purposes. This analysis is supported by a technical advice memorandum issued by the IRS National Office in which the IRS held that the taxpayer was entitled to use graded interest rates in computing tax reserves for structured settlement annuities.[7] The IRS reached this conclusion because it determined that the use of graded interest rates was a permissible interpretation of CARVM. That is, the company was permitted to deviate from explicit use of the PSAIR or AFIR as of the issue date of the policy. In other words, although the applicable interest rate is determined for "the calendar year in which the contract was issued" under section 807(d), the reserve method in effect at the time the contract is issued determines the means by which the interest rate is selected.[8]

In short, resolution of this problem boils down to whether the concept of issue date as used in section 807(d) is exclusively a tax term to be read literally (*i.e.,* when the contract in fact was issued) or whether it is a term of art to be read in the context of its meaning under the Standard Valuation Law. Surprisingly, this is still an unresolved issue. However, to our knowledge, the majority of insurers currently use the claim incurral date for claim reserves, in part for the pragmatic reason that the claim reserve data record generally does not contain the original contract issue date.

WHAT TABLES SHOULD BE USED TO COMPUTE TAX RESERVES FOR HEALTH INSURANCE?

The Code defines the tables to be used as of the contract issue date as follows:

> IN GENERAL-The term "prevailing commissioners' standard tables" means, with respect to any contract, the most recent commissioners' standard tables prescribed by the [NAIC] which are permitted to be used in computing reserves for that type of contract **under the insurance laws** of at least 26 States when the contract was issued. **(Emphasis added.)**[9]

Note that it is not sufficient for a state official merely to indicate a preference for a particular table (by statutory examination or otherwise). Rather, the insurance laws and regulations of a state must include the table as a requirement to be followed.

As noted previously, historical state-by-state adoption of mortality and morbidity tables for health insurance has been extremely sporadic, with very few tables reaching the 26-state criterion for "prevailing." This led to the above-cited Treas. Reg. § 1.807-1, which prescribes tables in the absence of prevailing tables.[10] That regulation specifically excludes product lines for which a table has been adopted by 26 or more states. That is, once a particular table has been so adopted, that part of the Treas. Reg. is then superseded.

Moreover, where this regulation prescribes use of the statutory table for tax purposes, it does not deal with the issue of changes in the statutory table on in-force business (which happens more frequently in health insurance than in life insurance). Is the old tax basis table to be locked in at issue, effectively accommodated and the change recognized in the year of change, or subjected to a section 807(f) 10-year spread on the change? There is little guidance on this point.

In 2001 an event took place that could have a significant impact on the proper table to use for health insurance tax reserves. That was the year that codification of Statutory Accounting Principles took place. Beginning shortly after "Codification," and the corresponding annual publication of the "Accounting Practices and Procedures Manual" ("APPM"), most states enacted statutes or regulations that automatically adopt the APPM by reference. The question, then, is: "Does a state statute or regulation adopting the APPM by reference con-

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The adoption of the APPM may have an effect on when adjustments to the table are appropriate.

stitute the ***law*** of such state adopting the table included in the APPM for purposes of the 26-state rules under section 807(d)?" It would appear so. A counterargument would be that the APPM only specifies accounting requirements and does not constitute a change in the valuation statutes or regulations of the state. However, there appears to be no reason why such "adoption by reference" fails to qualify as the law of the state affecting the tax reserve basis. This could mean that all the prescribed statutory morbidity tables (and health insurance mortality decrement tables) listed in Appendix A-010 of the APPM become prevailing tables once they are included therein, although the answer is not certain.[11]

In addition, inasmuch as statutory guidance on health insurance morbidity assumptions is subject to more frequent change than the equivalent statutory guidance on life insurance, Appendix A-010 requires that, for example, in the event of insufficient reserves, due to inadequate tabular morbidity assumptions, new basis reserves must be computed using increased morbidity assumptions, which becomes "the minimum standard.[12]

WHEN AND UNDER WHAT CIRCUMSTANCES MUST A COMPANY ADJUST THE PREVAILING TABLE IN COMPUTING HEALTH INSURANCE TAX RESERVES?

Section 807(d)(2) prescribes that a company compute the amount of the life insurance reserves for a contract using the prevailing commissioners' standard table for mortality and morbidity "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." Whether such adjustment is mandatory or optional varies by the guidance in question. The above Code language appears to make it mandatory. However, in explaining this provision, the legislative history of the 1984 Act suggests that an adjustment is possibly optional: "[c]ompanies ***may*** adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks" otherwise not taken into account;[13] "a company ***may*** use an appropriate multiple of a table."[14] (Emphasis added.) However, there is language in a TAM[15] that suggests that such adjustment is mandatory. The IRS National Office reasoned that, because the Code requires the company to use the prevailing commissioners' standard table irrespective of whether it used the same table for its annual statement reserves, the adjustment to the prevailing table is independent of what the company computed for annual statement purposes. Further, the term, "may" contains two alternative meanings: either that the company has an option whether to adjust, or that the particular fact pattern will dictate whether an adjustment must be made. The latter meaning would imply that the adjustment is mandatory. Indeed this latter meaning may be the only way to harmonize the legislative history with the explicit language of the Code.

Most disputes in this area regarding whether such an adjustment can be made at all revolve around whether the risks for which a company has made adjustments to the prevailing table are in fact risks present at the issue date of the contract which are not otherwise taken into account in the prevailing table. See for example, TAM 200416009[16] where the IRS National Office agreed with an agent's disallowance of a prevailing table adjustment for the company's own experience subsequent to issue.

The adoption of the APPM may have an effect on when adjustments to the table are appropriate. Although the APPM, in practice, may prescribe tables required to be used for tax purposes, it may not be sufficient, or even workable, for the APPM to prescribe a simple "adjustment to a table" that would rise to the level of a "standard table," when such adjustment is performed on a gross, overall basis (*e.g.,* without regard to issue ages, attained ages, gender, or other variables essential in determination of an actuarially appropriate table). One reason that such adjustment may not rise to the level of a "standard table" is that it would appear to contradict the "adjusted as appropriate" language of section 807(d)(2)(C). That is, the "adjusted as appropriate" language would not have a base reference table from which to make an adjustment. For example, for disability income claim reserves, the APPM, Appendix A-010, prescribes Table CIDC for claim incurrals beginning Jan. 1, 2002. The CIDC table in fact simply consists of a set of adjustment factors to the l985 CIDA table that vary only by duration from disablement. It is virtually impossible, from that adjusted table, to understand how to adjust the CIDC table based on, for example, liberalized contractual provisions defining compensable disability. Further, section 807(d)(2)(C) is not explicit as to the adjustment procedure to employ, thus giving the insurance company significant latitude to employ a professionally reasonable "adjustment as appropriate." As a result, it appears that one possible adjustment procedure

would be to unwind the CIDC adjustment factors to get back to the l985 CIDA "Standard Table," and potentially adjust the latter for the difference in contractual provisions from the experience underlying that 1985 CIDA standard table.

IS A MODIFICATION TO RESERVE ASSUMPTIONS A CHANGE IN BASIS OF RESERVES SUBJECT TO THE TEN-YEAR SPREAD RULE OF SECTION 807(f)?

The answer to this question depends on whether the adjustment to reserve assumptions would be a change in method of accounting under general tax rules absent section 807(f). In general, section 807(f) provides a special rule that requires a ten-year spread of reserve differences that arise when there has been a change in basis of computing reserves. Courts and the IRS agree that the rule comes into place only where a change in method of accounting otherwise would occur.[17] Usually, changes in assumptions in life insurance reserve calculations are subject to section 807(f) because the method of accounting adopted from the outset contemplates that the reserve assumptions will remain static until the contract matures. The same is not true for other types of reserves, particularly claim reserves.[18] In analyzing whether a change in health insurance reserves is subject to section 807(f), the operative issue is whether the reserve method itself assumes that periodic updates to assumptions will be made (as may be the case for claim reserves) or whether the method assumes that assumptions will not change. For example, for IBNR disability claim reserves, the method for calculating termination rates in the first 24 months from disablement may assume that assumptions will be continuously updated as experience emerges. When such assumptions are routinely and periodically adjusted, the change in reserves should not be subject to section 807(f). For other changes in assumptions, however, it may be more difficult to resolve whether the ten-year spread rule applies.

CONCLUSION

Health insurance tax reserve issues may receive less attention from the IRS, and even from *TAXING TIMES'* authors and readers, than tax reserves for life insurance and annuity contracts. Moreover, providing guidance on health insurance tax reserves is unlikely to be a major focus of the IRS in the near future relative to other issues. However, the tax reserve issues health actuaries must deal with are no less complex. ◀

END NOTES

1 All references to "section" or "Code section" are to the Internal Revenue Code of 1986, as amended.

2 *See* Notice 2010-29, 2009-16 I.R.B. 849.

3 Section 807(d)(2)(C).

4 PLR 8601013 (Sept. 30, 1985).

5 Ordinarily, only health insurance contract and claim reserves that are computed using morbidity and interest rate assumptions qualify as life insurance reserves. However, Treas. Reg. § 1.801-3(d) requires that, in order to be classified as a guaranteed renewable contract, a reserve in addition to the unearned premium must be held. Therefore, premium reserves generally qualify for life insurance reserve treatment only if an additional reserve also is held for active lives.

6 NAIC Accounting Practices and Procedures Manual, Appendix A-010, Exhibit 1, Paragraph 4.

7 TAM 200108002 (Oct. 24, 2000).

8 Under this analysis, there may be more than one "issue date" for tax purposes for a health insurance contract – an issue date for contract reserves and another issue date for claim reserves. There may even be a third issue date because the AFIR is effective only for contracts "issued" in tax years beginning after 1987. Pub. L. 100-23, Section 10241.

9 Section 807(d)(5)(A).

10 Authority is given to Treasury to prescribe such tables under section 807(d)(5)(C).

11 Section 807(d)(4)(B)(i) contains similar language for the interest assumption. Thus, if the APPM mentions a statutory interest standard, it generates issues similar to those discussed above relating to tables.

12 NAIC Accounting Practices and Procedures Manual, Appendix A-010, Paragraph 29.

13 H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1416 (1984).

14 S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 542 (1984). *See also,* FSA 1992 WL 1466112 (Aug. 28, 1992), which considered adjustments to the prevailing tables in the context of structured settlement annuities and annuities and advised the IRS agent that a company *may* be required to adjust the mortality factors from the prevailing table for purposes of computing its tax reserves even though the company did not make an adjustment to the table in computing its annual statement reserves for the contracts.

15 TAM 9251005 (Sept. 9, 1992).

16 TAM 200416009 (Dec. 15, 2003).

17 *American General Life & Accident Ins. Co. v. U.S.*, 90-1 U.S.T.C. 50, 010 (M. D. Tenn. 1989); Rev. Rul. 94-74, 1994-2 C.B. 157. For a complete discussion of section 807(f) *see, Winslow & Jones, Change in Basis of Computing Reserves – Is It or Isn't It? 6 TAXING TIMES 9 (Feb. 2010).*

18 *E.g.,* TAM 200115002 (Dec. 21, 2000).

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IRS RULES ON AMERICAN FINANCIAL

By Richard N. Bush

INTRODUCTION

The United States district court for the Southern District of Ohio recently issued its opinion in *American Financial Group and Consolidated Subsidiaries v. United States*. The issue in the case as framed by the Internal Revenue Service (IRS) was whether Actuarial Guideline XXXIII (AG 33) applies retroactively or prospectively to the calculation of reserves for deferred annuity contracts. The taxpayer took a more nuanced view. The taxpayer broadly argued that actuarial guidelines (sometimes hereinafter referred to simply as "guidelines") apply retroactively. The taxpayer also argued, however, that even if a guideline generally applies prospectively, if the guideline simply adopts a prior interpretation of CARVM, the taxpayer is obligated to compute its tax reserves using the method adopted by the guideline. Here, the taxpayer argued, the changes it made as the result of the adoption of AG 33 were made to compute its reserves to the way in which the reserves should have always been computed under CARVM.

Sometimes guidelines are specifically intended to be temporary and are periodically revised.

BACKGROUND

Section 807(c)(1) allows a deduction for "life insurance reserves" as defined in section 816(b)(1). Section 816(b)(1) defines life insurance reserves as amounts computed on the basis of recognized mortality tables and assumed rates of interest. Section 807(d) generally defines the method of computing life insurance reserves. Section 807(e) sets out various special rules for computing life insurance reserves.

Section 807(d)(1) defines the amount of life insurance reserve for any contract as the greater of the net surrender value of the contract or the reserve determined according to section 807(d)(2). Section 807(d)(2) provides rules that determine the method that must be used to calculate reserves,[1] the interest rate that must be used[2] and the mortality table that must be used.[3] Section 807(d) was meant to provide for a more realistic measure of the company's liabilities by "imposing specific rules for the computation of tax reserves that result in a reserve which approximates the least conservative (smallest) reserve that would be required under the prevailing law of the States."[4]

In computing the federally prescribed reserve, a company should begin with its annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well the elimination of any net deferred and uncollected premiums and the elimination of any reserve in respect of excess interest.[5] Thus, except for the federally prescribed items, the methods and assumptions employed in computing the federally prescribed reserve (*e.g.*, whether to use a continuous or curtate function) should be consistent with those employed in computing a company's statutory reserve.[6]

Actuarial guidelines generally are developed in response to a state insurance department to aid "in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of the original drafting of a particular statute. The Actuarial Task Force, in developing its interpretation or guideline, must often consider the intent of the statute, the reasons for initially adopting the statute and the current situation."[7] Guidelines are published "for those situations which are sufficiently common to all states, [such] that the publishing of actuarial guideline on these topics would be beneficial to the regulatory officials in each state and would promote uniformity in regulation which is beneficial to everyone."[8] The guidelines "are not intended to be viewed as statutory revisions but merely as a guide in applying a statute to a specific circumstance."[9]

Sometimes guidelines are specifically intended to be temporary and are periodically revised. For example, Actuarial Guideline 38 (AG 38) was first adopted in September 2002 to deal with the appropriate treatment of secondary guarantees under Model Regulation XXX (the Valuation of Life

Insurance Policies Model Regulation). AG 38 was modified in October 2005 and there are three separate methodologies that apply to contracts. One set of guidance applies to contracts issued prior to July 1, 2005.[10] A second set of guidance applies to contracts issued on or after July 1, 2005 and prior to Dec. 31, 2006 and for policies issued on or after Jan. 1, 2011.[11] The third set of guidance applies to policies issued on or after Jan. 1, 2007 and on or prior to Dec. 31, 2010.[12]

In other situations, it is clear that a guideline prescribes a method for computing reserves that changes a method adopted in a prior guideline. Actuarial Guideline LXIII (AG 43), for example, clearly adopts a method for computing reserves for variable annuities that is different from, and in some cases, materially different from, prior guidance in Actuarial Guideline 34 (AG 34) and Actuarial Guideline 39 (AG 39).

There also may be situations in which a guideline adopts a method for which there was no previous guidance issued by the National Association of Insurance Commissioners (NAIC) (or prevailing state interpretation[13]) or where the prior guidance specifically permits alternative methods of computing reserves.[14] When there is no guidance from the NAIC or prevailing state interpretation of CARVM (or CRVM), a company is required to use its statutory reserve method (assuming it is consistent with CARVM) to compute its tax reserves, adjusted as necessary for interest rates and mortality tables.

A company is permitted to change its statutory reserve method (in the absence of contrary guidance and with state permission) and its tax reserve method will follow the new statutory method. If a company changes its statutory reserve method to conform to a new actuarial guideline, the new guideline is the company's statutory reserve method and should be followed for tax purposes in the absence of prior guidance or a prevailing State interpretation. It is not that the new guideline applies retroactively. It is just that the taxpayer is computing its tax reserves according to its statutory reserve method.

That a company may use a newly enacted guideline in the absence of a prior prevailing state interpretation is made clear in the committee reports. The committee reports specifically allow a company to use the Universal Life Model Regulation or the Long-Term Care Model Regulation for policies issued prior to the adoption of these regulations by the various states because there was no prior prevailing interpretation of how to compute reserves for these contracts prior to the adoption of the model regulations.[15] If a company can use a newly adopted model regulation for contracts issued prior to its adoption by the NAIC in the absence of a prior NAIC prescribed method to compute its tax reserves, there is no reason to preclude the use of a new guideline in the same circumstances.

It is this latter situation in which the taxpayer found itself in *American Financial*. AG 33 adopted guidance where there had been no prior NAIC guidance (at least for the particular kinds of benefits for which the reserves were at issue). Thus, the taxpayer was required to compute its tax reserves using its statutory reserve method. When AG 33 was adopted, AG 33 became its statutory reserve method. The company therefore was required to follow AG 33 for tax purposes as well. The IRS seemed to agree that there was no prior guidance or prevailing state interpretation of the application of CARVM prior to the adoption of AG 33. If the taxpayer could not apply AG 33, one wonders what the taxpayer should have used to compute its tax reserves given that its statutory reserves were computed using AG 33.

AG 33 clarified how to compute reserves (for the changes made by the taxpayer) where there was either two or more ways of computing reserves or where there was simply no prior guidance at all. Before the adoption of AG 33, the taxpayer should have followed its statutory reserve method to compute its tax reserves. When AG 33 was adopted, the taxpayer changed the method it used to compute its statutory reserves. The taxpayer was required to use its statutory reserve method to compute its tax reserves and it just happens that AG 33 was its statutory reserve method.

THE AMERICAN FINANCIAL GROUP CASE

Great American Life Insurance Company ("GALIC") issued deferred annuity contracts and at Dec. 31, 1995 reported tax reserves on these contracts of almost $5 billion. Virtually all of these policies were issued on or after Jan. 1, 1981. These contracts guaranteed a specified purchase rate for annuitization and also guaranteed a minimum crediting rate. An upper tier provided an account value which was used to determine annuity payments in the event an annuity benefit was elected. A lower tier was used to calculate the net surrender value in the event the policy was surrendered.

In 1995, the NAIC issued AG 33 to address the treatment of reserves for annuity contracts. AG 33 was effective on Dec. 31, 1995 for all contracts issued on or after Jan. 1, 1981.

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The guideline notes that "[t]he purpose of this guideline is to codify the basic interpretation of CARVM and does not constitute a change in method or basis from any previously used method by clarifying the assumptions and methodologies which will comply with the intent of the SVL." The preamble to the guideline also noted that "[i]ndustry practices and methods of reserving for individual annuity benefit streams have not been found to be consistent."

On June 5, 1997, a revised AG 33 was adopted. This Guideline was titled, "Determining CARVM reserves for Annuity Contracts with Elective Benefits." The revised Guideline states:

> The major purpose of this Actuarial Guideline is to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams. Some of the areas of clarification include: the valuation of annuitization benefits; the application of incidence rates in CARVM; the application of the integrated benefit stream approach in CARVM; how to determine valuation interest rates and mortality tables for multiple benefit streams; and certain practical considerations regarding multiple benefit streams.

Like the original version of AG 33, the revised version of AG 33 states that its purpose is to "codify the basic interpretation of CARVM and does not constitute a change of method or basis from any previously used method, by clarifying the assumptions and methodologies which will comply with the intent of the SVL."

As a result of the publication of AG 33 and prompted by a triennial examination by Ohio (its domestic regulator), GALIC underwent a study of its reserves and made changes to how it had previously computed the reserves. As a result of the study, GALIC increased its statutory reserves in 1995 by about $69 million and its tax reserves by about $59 million.

The changes to the reserve computation in 1995 were made for three reasons: 1) a change in the interest rate assumption used to classify a three-year annuitization benefit on the contracts;[16] 2) a change to the guarantee duration assumption used to calculate the interest rate for certain policies;[17] and 3) a partial surrender/partial annuitization option was taken into account that had been ignored in the previous calculation of reserves.[18] In all cases, GALIC spread the change in reserves over 10 years as required by section 807(f). These changes were made by GALIC so that its reserves were calculated according to AG 33.[19]

The IRS argued that for tax purposes when a new actuarial guideline is published it becomes the tax method for contracts issued only after the date the Guideline becomes effective, relying on the language in section 807(d)(3)(B)(ii) that defines CARVM as the method prescribed by the NAIC "which is in effect on the date of the issuance of the contract." In other words, actuarial guidelines cannot be applied retroactively. GALIC argued that AG 33 did not change the definition of CARVM and therefore applied to all of its in-force contracts (at least those contracts issued on or after Jan. 1, 1981).[20]

The court agreed with GALIC,[21] concluding that AG 33 "did not change the definition of the CARVM. Instead, AG 33 was interpreting the proper application of the CARVM." In reaching its conclusion, the court referred to an opinion letter to the Ohio Department of Insurance that stated that AG 33 applies to "all annuity contracts issued on or after January 1, 1981, because AG 33 was a clarification of existing law and did not constitute a change of method from any previously required method for valuing reserves." The Ohio Department opinion letter concludes:

> The clear intent of AG 33 can be found in the four-corners of the guideline itself: (1) there were inconsistent methods and practices in the insurance industry for reserving under CARVM for annuities with multiple benefit streams; (2) AG 33 is intended to clarify the basic interpretation of CARVM by clarifying the assumptions and

> methodologies which will comply with the intent of the SVL; and (3) it does not constitute a change of method or basis from any previously used method. Actuarial guidelines by their very nature are intended to clarify various interpretations of the SVL between 50 states and cannot constitute a change or amendment of the SVL.

Finally, the court noted that there was testimony that indicates that NAIC guidelines are "only interpretations of the CARVM."

An appeal in this case would go to the Sixth Circuit Court of Appeals. An appeal from the district court must be initiated within 60 days from the entry of the judgment,[22] which requires an agreement of the amount of tax owed, and it is unclear when this process will be completed. There is no indication whether the Government will appeal, but it seems likely that given the importance of the issue an appeal will be filed.

THE TAX RESERVE METHOD AND THE APPLICATION OF GUIDELINES

Section 807(d)(3)(A)(ii) defines the tax reserve method for annuity contracts as:

> (ii) ANNUITY CONTRACTS.—The CARVM in the case of a contract covered by the CARVM.
>
> Section 807(d)(3)(B)(ii) defines CARVM as:
>
> (ii) CARVM.—The term "CARVM" means the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners *which is in effect on the date of the issuance of the contract.* [Emphasis added.]

Although not framed by the parties in this way, one way of looking at the issue is whether the "in effect" language in section 807(d)(3)(B)(ii) means that tax reserves must be computed according to the NAIC interpretation of CARVM in effect when the contract is issued or whether, if the NAIC changes its interpretation, the new interpretation applies retroactively. Importantly, section 807(d)(3)(B)(ii) does not address the situation in which the NAIC has not adopted an interpretation of CARVM prior to the date a new guideline is adopted (or there is not a prevailing view of the states on an interpretation of CARVM).

The distinction is important. The court was not faced with the situation in which a new guideline adopts guidance that changes a prior interpretation of CARVM. The court noted that the Standard Valuation Law definition of CARVM remained unchanged from 1976 through 2006 and that "AG 33 did not amend the SVL, nor did it change the definition of the CARVM. Instead, AG 33 was interpreting the proper application of the CARVM." The court noted that guidelines are not intended to be statutory revisions but are only "interpretations" of CARVM.

This is consistent with the statutory language in section 807(d)(3) and the legislative history makes this clear. Given that the legislative history specifically states that the prevailing state interpretation of CARVM must be used for tax purposes (and that actuarial guidelines, in effect, adopt a prevailing state interpretation) it seems clear that Congress intended that the definition of CARVM in the Code to refer broadly to how CARVM is interpreted by the NAIC at the time a contract is issued.

Where the NAIC has acted through an actuarial guideline to interpret CARVM, the actuarial guideline defines CARVM for tax purposes for contracts issued after its adoption and until the NAIC changes the method adopted in the guideline.[23] When a new guideline is issued, the previously adopted guideline continues to apply for tax purposes to contracts issued after the date the previously adopted guideline was adopted and stops applying to contracts that are issued after new guidance is adopted.[24]

Where the NAIC has acted through an actuarial guideline to interpret CARVM, the actuarial guideline defines CARVM for tax purposes for contracts issued after its adoption and until the NAIC changes the method adopted in the guideline.

For example, the legislative history states that it was intended that if the NAIC acted in 1984 with respect to the computation of annuity reserves, and clarified that surrender penalties are to be disregarded under CARVM, then this "clarification" was to be given effect as of the date the contract was issued. It was recognized that

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"*giving retroactive effect to a NAIC recommendation … is an exception to the general rule that reserves must be computed for tax purposes under the method prescribed by the NAIC (or the prevailing State interpretation thereof) in effect on the date of issuance of the contract*."[25] [Emphasis supplied.]

GALIC correctly points out that CARVM always required a company to compute its reserves by taking into account partial surrenders and it would have been inappropriate to ignore these benefits in the CARVM calculation. What AG 33 did was to clarify how to compute the reserve for a contract with these benefits. Prior to the adoption of AG 33, there were generally two ways of treating free partial withdrawals: 1) Approximate Method; or 2) The Exact Method.[26] AG 33 adopted the Exact Method. Since CARVM in the absence of AG 33 required GALIC to take these benefits into account (whether using the Approximate Method or the Exact Method), GALIC appropriately took these benefits into account in 1995 regardless of the adoption by the NAIC of AG 33.

UNRESOLVED ISSUES IF A GUIDELINE APPLIES RETROACTIVELY

Not decided by the court is, assuming a new guideline applies retroactively, whether it applies to years before the new interpretation (guideline) is adopted. For example, should AG 33 apply to tax years before 1995 (the year of its adoption) to the extent those years were not yet closed by the statute of limitations? This issue was not before the court.

In addition, applying a guideline retroactively may implicate section 807(d)(2)(B) and (C). Section 807(d)(2)(B) provides that for contracts issued on or after Jan. 1, 1988, the amount of the reserve is determined by using the greater of i) the applicable federal interest rate, or ii) the prevailing State assumed interest rate. Section 807(d)(2)(C) provides that a company must use the prevailing commissioners' standard tables for mortality and morbidity. The prevailing commissioners' mortality table is defined in section 807(d)(5)(A) as the "most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued."

It should be pointed out that applying a new guideline retroactively is usually a taxpayer-friendly result, but clearly it is not always the case.

For example, mortality rates under AG 43 are specified as 70 percent of the 1994 Variable Annuity MGDB Mortality Tables (1994 MGDB tables) through age 85 increasing by 1 percent each year to 100 percent of the 1994 MGDB tables at age 115.[27] On the other hand, AG 34 requires the use of the 1994 Group Annuity Mortality Basic Table (1994 GAMB), increased by 10 percent for margins and contingencies, without projection, to discount projected death benefits during the accumulation phase.

Since the prevailing table for contracts issued prior to the adoption of AG 43 is the table adopted in AG 34 (for MGDBs), query whether the AG 34 mortality table must be substituted for the AG 43 mortality table for contracts issued prior to Dec. 31, 2009 (assuming AG 43 applies retroactively). To the contrary, one could argue there is, in fact, no prescribed mortality table because AG 43 adopts an entirely new method of computing reserves and therefore there is no mortality table that applies prior to its adoption.

CONCLUSIONS AND NOTICE 2010-29

It should be pointed out that applying a new guideline retroactively is usually a taxpayer-friendly result, but clearly it is not always the case. If the new guidance results in stronger reserves, a company generally will get larger tax deductions under the new method. And if a new guideline results in weaker reserves than prior guidance, most companies are not willing to hold stronger statutory reserves just to get a tax deduction because the cost to capital is too great. Thus, although the statutory cap reduces the tax reserve, most companies will not hold a higher statutory reserve (using the prior guideline). To the extent tax reserves would have been less than statutory reserves because of the application of tax mortality or interest rates, any statutory and tax reserve difference may be eliminated.

In some cases, however, stronger reserves can result in a tax cost because of the 10-year spread rule in section 807(f) if the tax reserves would have increased to the new reserves in less than 10 years. For example, assume a contract that has a net

surrender value of $100 and a tax reserve of $100 computed under an existing guideline. Under a new guideline, the tax reserve is $110. The company is required to take the $10 increase as the result of the new method as a deduction over 10 years under section 807(f). Suppose in the next year, however, the net surrender value is $115 and the tax reserve under the new method is also $115. The company is entitled to a $5 deduction in the second year. If the company had remained on the existing method, however, it would have been entitled to a tax deduction of $15 in the second year—a much better result than a 10-year spread in year one and a $5 deduction in year 2.

Finally, this leads us to Notice 2010-29. The Notice provides interim guidance under AG 43. The Notice specifically provides that the Standard Scenario Amount determined under AG 43 is treated as a life insurance reserve. The applicable effective date for contracts is set forth in section 3.03. Under this section:

- For a contract issued before Dec. 31, 2009, the tax reserve method is the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43;[28]
- For a contract issued on or after Dec. 31, 2009, the tax reserve method with respect is the method prescribed in AG 43.[29]
- Whether a taxpayer delays implementation of AG 43 with permission of its domiciliary insurance commissioner has no effect on the determination of the amount of the reserve.[30]

The Notice provides further that the prevailing state assumed interest rate with respect to a contract to which AG 43 applies for tax purposes is the highest assumed interest rate permitted to be used in computing the Standard Scenario Amount as of the beginning of the calendar year in which the contract was issued[31] and the prevailing commissioners' standard tables with respect to a contract to which AG 43 applies for tax purposes is the table prescribed by the NAIC that are permitted to be used in computing the Standard Scenario Amount for such a contract.[32]

Read broadly, the court's opinion means that any guideline applies retroactively so that AG 43 would apply to all contracts issued on or after Jan. 1, 1981. Read narrowly and applied to its facts, the case means only that where a guideline does not change a prior interpretation of CARVM, it applies retroactively. In this latter event, the court's opinion in not inconsistent with Notice 2010-29's conclusion that AG 43 applies only prospectively to the extent prior guidelines define the tax reserve method for contracts issued prior to Dec. 31, 2009. As discussed, this article agrees that AG 43 applies prospectively for contracts issued when there was either prior actuarial guidance (such as AG 34) in effect when the contract was issued or there was a prevailing state interpretation of CARVM in effect at the time the contract was issued.

Of course, that prior guidance must be the tax reserve method. For example, consistent with Notice 2010-29, one might conclude that the Asset Adequacy Reserve in AG 39 is not allowed as a tax deduction. The reference to relevant actuarial guidance does not mean that the prior guidance automatically defines the tax reserve method. Similarly, neither the court's opinion nor Notice 2010-29 addresses what should happen if the prior guidance was meant to be only temporary.

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END NOTES

1 Section 807(d)(2)(A).
2 Section 807(d)(2)(B).
3 Section 807(d)(2)(C).
4 General Explanation of the Tax Reform Act of 1984, Joint Committee on Taxation, p. 578 (1984 Blue Book); S. Prt. 169, 98th Cong., 2d Sess., at pp. 521; H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess., at 1397.
5 See discussion in an article written by Peter H. Winslow and Susan J. Hotinel, IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date, in Taxing Times, Volume 1, Issue 2 (Sept. 2005).
6 1984 Blue Book, page 599. Similar language appears in the legislative history in the Senate Finance Committee Report, S. Prt. No. 169, 98th Cong., 2d Sess., at p 540.
7 Preamble to NAIC Actuarial Guidelines.
8 Preamble to NAIC Actuarial Guidelines.
9 Preamble to NAIC Actuarial Guidelines.
10 AG 38, Paragraph 8A.
11 AG 38, Paragraph 8B.
12 AG 38, Paragraph 8C.

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END NOTES (CONTINUED FROM PAGE 15)

[13] This article does not attempt to define what is meant by a prevailing state interpretation, for example, whether this means that 26 states must have adopted a particular interpretation, and what it means for a state to "adopt" an interpretation in the absence of published guidance by the state. The IRS might be expected to argue that aprevailing state interpretation should be interpreted as the lowest reserve allowed by 26 states even if there is no specific interpretation adopted by 26 states. As an example, a company may provide that at annuitization that a policyholder can use the then-current rates available to new purchasers of immediate annuities if those rates will provide a higher annuity benefit than the guaranteed rates. Prior to the adoption of AG 33, it appears that no reserve was required for these benefits by 26 states. AG 33 likewise does not require any reserve for this benefit except that it does require a minimum reserve of 93percent of the account value. Accordingly, a company could not hold a tax reserve using 93 percent of the account value after the adoption of AG 33 because this was a new requirement adopted by AG 33 and the prevailing state interpretation of CARVM prior to the adoption of AG 33 would *not* have required a minimum reserve to be held.

[14] S. Prt. No. 169, 98th Cong., 2d Sess., at p. 541; TAM 200108002; TAM 200448046.

[15] 1984 Blue Book, p. 601; General Explanation of the Tax Legislation Enacted in the 104th Congress, Joint Committee Print, pp. 1726-1727.

[16] The policies allowed a policy owner to withdraw funds based on the upper-tier annuity value over three years without any adjustment.

[17] Prior to the change, GALIC measured guarantee duration as the number of years between the date of issue of the policy and the date annuity benefits under the policy were assumed to commence. This led GALIC to use a guarantee duration of "more than 10 but not more than 20" in determining the interest rate. In addition, GALIC changed the guarantee duration by treating the benefits under the contracts as having cash settlement options rather than as contracts without cash settlement options.

[18] The first change resulted in an increase of about $30 million in reserves; the second change resulted in an increase of about $7 million; and the third change resulted in an increase of about $18 million.

[19] GALIC argued in the alternative that the changes it made to the interest rate assumptions were not required by AG 33 but instead these changes were made to conform to prior NAIC guidance. Therefore, according to GALIC, even if AG 33 applied prospectively only, it should be entitled to make these changes to its tax reserve calculation. The court refused to grant summary judgment on this issue saying that there were insufficient facts in the record before it to reach a conclusion on whether the interest rate assumptions were changes made by AG 33. The court appeared skeptical, however, noting that the changes made by GALIC were required by AG 33 and that GALIC did not make these changes until AG 33 was adopted. In any event, because the court concluded that AG 33 applied to all of GALIC's contracts, resolution of this issue was moot.

[20] For contracts issued prior to Jan. 1, 1981 it is unclear what the court would have decided because by its terms AG 33 does not apply to these contracts.
In Rev. Rul. 2002-6, the Service addressed changes made by a company to conform to AG 33. In computing its end of the year (EOY) life insurance reserves for the annuity contracts for taxable years 1999 and 2000, the company did not take into account several specific factors set forth by AG 33. In 2001, the company modified its reserve computation to take those factors into account in computing its EOY 2001 reserves for annuity contracts. The Service concluded that the change was subject to a 10-year spread. The Service stated that in the alternative, in accordance with Rev. Rul. 94-74, the company could file amended returns for 1999 and 2000 and recalculate its tax reserves for those years in accordance with AG 33. The ruling does not address the issue of whether a company that had used a different method prior to the adoption of a guideline can change its method to the method adopted by the guideline. In the ruling, the contracts issued should always have been computed according to AG 33 because the guideline was the NAIC prescribed method at the date the contracts were issued.

[21] Both parties moved for summary judgment. Summary judgment is a procedure used to dispose of a case without a trial. It is used when there is no dispute as to the material facts and a party is entitled to judgment as a matter of law.

[22] Rule 4(a), Federal Rules of Appellare Procedure.

[23] In TAM 200328006, the IRS ruled that Actuarial Guideline XXXIII can be used in computing tax reserves only for annuity contracts that were issued on the date on which the guideline took effect, or the date of adoption by the National Association of Insurance Commissioners, whichever is later.

[24] The IRS seems to have agreed with this position in an earlier TAM. TAM 200108002 addressed the use of different interest rates used in the computation of structured settlement reserves prior to the adoption of Guideline IX-B in 1989. In this TAM, the company computed its statutory reserves for structured settlements using a method that was consistent with CARVM. There was no prescribed NAIC method for computing statutory reserves. In addition, there was no prevailing State interpretation. Therefore, the IRS ruled that tax reserves must be computed using the statutory method. Although not at issue, the TAM makes it clear that when the company ultimately adopted Guideline IX-B for statutory purposes in later years, the company used Guideline IX-B for tax reserves as well.

[25] Blue Book, p. 601; S. Rep. No. 313, 99th Cong. 2d Sess. 964 (1986), 1986-3 CB (Vol. 3) C.B. 964. In 1985, the NAIC adopted the recommendation of the Life and Health Actuarial Task Force in Actuarial Guideline XIII regarding the computation of CARVM as it dealt with surrender penalties. The guideline applied retroactively to all annuity contracts issued prior to its issue. The guideline was adopted because "differences in interpretation of CARVM have developed in practice. … [The] guideline is *intended to clarify* (emphasis supplied) which surrender charge factors may be taken into account and which are to be disregarded under CARVM."

[26] Under the Approximate Method, any surrender penalty was reduced by the amount of the free partial withdrawal. For example, assume a company had a 5 percent surrender penalty, and a 10 percent free partial withdrawal. The CARVM reserve would be calculated using a 4.5 percent surrender penalty to approximate the effect of the free partial withdrawals. Under the Exact Method, a company would consider each and every partial withdrawal. Thus, a company would project a policy to the next anniversary both assuming no partial withdrawal is made and assuming a full partial withdrawal is made. A giant tree is generated to project values.

[27] AG 43, Appendix 3, Paragraph A3.3)C)5).

[28] Notice 2010-29, Section 3.03(a).

[29] Notice 2010-29, Section 3.03(b).

[30] Notice 2010-29, Section 3.03(e).

[31] Notice 2010-29, Section 3.03(c).

[32] Notice 2010-29, Section 3.03(d).

TAPPING A NEW REVENUE SOURCE—CONGRESS EXPANDS THE MEDICARE TAX BASE TO INCLUDE INCOME FROM "ANNUITIES"

By John T. Adney and Alison R. Peak

Last March, Congress passed and the President signed the Patient Protection and Affordable Care Act[1] followed by the Health Care and Education Reconciliation Act,[2] which amended the former (collectively, the "Act"). While the overall impact of the massive health care reform legislation remains to be seen, one change is noteworthy for life insurance companies and their policyholders. Specifically, the Act altered the Medicare Hospital Insurance ("HI") tax by increasing the tax on the earned income amounts of high income taxpayers and by adding a new 3.8 percent tax on certain types of "net investment income" of those taxpayers (referred to herein as the "Investment Income Tax"[3]). As detailed below, of key importance to life insurers is that the definition of net investment income includes gross income from nonqualified "annuities" as well as from certain dispositions of property, which could implicate transactions involving life insurance contracts.

The first part of this article provides a brief background on the passage of the Act generally and the creation of the new Investment Income Tax in particular. The article next compares the existing provisions of the HI tax with the newly enacted provisions, and it then analyzes the import of the Investment Income Tax for annuities and, possibly, life insurance contracts. The article concludes with thoughts on the potential effect of the new tax on the annuity marketplace.

BACKGROUND

By late in 2009, health care reform proposals had gained considerable momentum due to a Democratic majority in both chambers of Congress, including a so-called supermajority of 60 votes in the Senate. Last January, however, this momentum slowed when Massachusetts elected a Republican senator, Scott Brown, bringing an end to that supermajority. By that point, two very different bills had passed the House and the Senate. For health care legislation to be enacted over Republican objections, the Obama Administration suggested using the "reconciliation" process, which only requires a simple majority vote for legislation to pass the Senate. On Feb. 22, 2010, the Obama Administration released a number of proposals designed to bridge the gap between the House and Senate bills. The congressional leadership agreed to follow this approach, ultimately resulting in passage of the legislation the following month.

In order to fund its proposals for concluding the health care enactment, the Obama Administration included several "policies to contain costs and ensure fiscal sustainability" (*i.e.*, revenue raisers), one of which was to "broaden the Medicare Hospital Insurance (HI) tax base for high-income taxpayers." The measures included an increase in the HI tax rate on the earned income of high income taxpayers and the addition of a new tax on high income taxpayers' "unearned" investment income (*i.e.*, the "Investment Income Tax"). The Act generally adopted the proposals to increase and expand the Medicare HI tax, estimated to raise over $210 billion in federal tax revenue over the ensuing 10 fiscal years.

DESCRIPTION OF NEW PROVISIONS

HI Tax on Earned Income

Currently, the HI tax is imposed on individuals as a percentage of their wages or self-employment income, *i.e.*, the tax generally applies only to income earned as compensation for personal services. The current tax rate is 2.9 percent, with employees paying half and their employers paying the other half (and with a self-employed individual paying tax at the full 2.9 percent rate subject to the deduction allowed on the individual's income tax return for a portion of this amount).

The Act increases by 0.9 percent the existing HI tax imposed on certain wage and self-employment income of high income taxpayers, effective for taxable years beginning after Dec. 31, 2012. This tax is added to the current employee share of the HI portion of payroll taxes on wages (FICA) and to the corresponding self-employment (SECA) tax. The 0.9 percent tax will apply to the extent that combined wage and self-employment income exceeds $200,000 for individuals or

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$250,000 for married taxpayers (filing joint returns). Unlike the thresholds for the 3.8 percent Investment Income Tax described more fully below, only wages and self-employment income are taken into account in determining whether a taxpayer has income in excess of the thresholds, *i.e.,* investment income is disregarded. The additional revenues from the 0.9 percent tax increase will be credited to the HI Trust Fund (as are current Medicare tax revenues), which generally funds Medicare benefits.

Investment Income Tax

As already noted, the Act includes a provision that expands the HI tax base for high income taxpayers to cover certain specified forms of investment income. Effective (like the tax rate increase just described) for taxable years beginning after Dec. 31, 2012, new section 1411[4] expands the base by applying the HI tax to investment income at the 3.8 percent rate. In the case of an individual,[5] the 3.8 percent rate applies to the lesser of a) "net investment income" or b) the excess of the taxpayer's modified adjusted gross income ("MAGI") over a specified income threshold.[6] The income thresholds are $250,000 for married couples filing jointly,[7] $125,000 for married couples filing separately,[8] and $200,000 for everyone else,[9] with none of these amounts being indexed for inflation in future years. MAGI is adjusted gross income, as that term is generally defined,[10] increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions allowed with respect to the foreign earned income).[11] Taxpayers with MAGI at or below the applicable income threshold are not subject to the tax, irrespective of their net investment income.

> *Example*: Assume that taxpayers filing a joint return have MAGI of $300,000, which exceeds the applicable income threshold by $50,000. The $50,000 excess amount effectively acts as a cap on their Investment Income Tax. If their net investment income exceeds $50,000, they will still pay the Investment Income Tax only on $50,000, and if their net investment income is less than $50,000, they will pay the Investment Income Tax only on that lesser amount. If they have no net investment income, or if their MAGI were less than $250,000, they would not owe the Investment Income Tax.

New section 1411(c) defines net investment income as 1) "gross income from interest, dividends, annuities, royalties, and rents," plus 2) any other gross income derived from a trade or business in which the taxpayer participates only passively or that is a business of trading in financial instruments or commodities, plus 3) net gain from dispositions of property to the extent taken into account in computing taxable income (subject to a special rule for property held in a noninvestment business), minus 4) otherwise allowable deductions properly allocable to the foregoing.

The additional revenues from the Investment Income Tax will not be set aside for the HI Trust Fund to fund Medicare benefits; instead the revenue raised by this tax will increase general federal revenues. Thus, while the new Investment Income Tax is labeled the "Unearned Income Medicare Contribution," it technically has nothing to do with Medicare funding and amounts to a new, general tax on the investment income of certain taxpayers.

WHAT INCOME IS SUBJECT TO THE INVESTMENT INCOME TAX?

Annuity Contracts

Perhaps the key aspect of the new Investment Income Tax for life insurance companies is the specific inclusion of "annuities" in the definition of "net investment income." It seems clear that the reference to annuities is not intended to reach the otherwise tax-deferred inside buildup of annuity contracts.[12] The definition refers to "gross income" from annuities (etc.), indicating that an item must be includible in gross income under existing tax law before it will be considered "net investment income" under the Act. Thus, only taxable distributions from annuity contracts would fall within the definition. For this purpose, section 61(a) provides that except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) annuities,[13] income from life insurance and endowment contracts,[14] and gains derived from dealings in property.[15] However, to the extent that another section of the Code or regulations provides specific treatment of any item of income, that other provision applies notwithstanding section 61 and the regulations thereunder.[16] To determine which amounts from an annuity are included in gross income, reference must be made to section 72.

Annuity payments. In particular, section 72(b)(1) provides that gross income does not include that part of any "amount received as an annuity" under an annuity contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date[17]) bears to the expected return under the contract (as of such date). In other words, section

72(b) provides rules to calculate an "exclusion ratio" for annuity payments received under an annuity contract once the contract is annuitized (*i.e.*, the value of the contract is applied to an annuity stream), subject to certain exceptions. The exclusion ratio operates to treat part of each annuity payment received as returning a portion of the contract holder's investment in the contract, with the remaining amount being includible in gross income. It is clear that this remaining amount, since it is includible in gross income, constitutes net investment income for purposes of the Investment Income Tax.

Partial distributions. Unless the reference to "annuities" in the definition of net investment income under the Investment Income Tax is limited to amounts received as an annuity under section 72(b), it is also necessary to consider the treatment of other income amounts from annuity contracts. In this regard, while the legislative history of the Act is silent on the matter,[18] the reference to annuities may be intended to sweep more broadly, encompassing all other amounts distributed from an annuity contract.[19] Since "annuities" as used in the Investment Income Tax is not defined for purposes of section 1411, the precise scope of the term is unclear.

Assuming that the broader reading of "annuities" was intended, the rules of section 72(e), which govern the tax treatment of amounts received under an annuity contract that are not received as an annuity, must be employed to determine the amounts of nonannuitized income that potentially are subject to the new tax. Generally, section 72(e)(2) provides that for distributions other than annuity payments (*i.e.*, "amounts not received as an annuity"), any amount received on or after the annuity starting date is included in gross income, and any amount received before the annuity starting date, other than in the case of a complete disposition (see below), is included in gross income to the extent that the income on the contract exceeds the investment in the contract.[20] Put differently, the entire amount of a distribution from an annuity contract that is not an annuity payment, but which is received after the annuity starting date, is included in gross income. Therefore, assuming the broader reading of the term "annuities" is used under the Investment Income Tax, that amount—a typical example of which is a policyholder dividend paid in cash—is fully included in the definition of net investment income for purposes of the new tax. And an amount such as a partial withdrawal that is received before the annuity starting date is included in net investment income to the extent it does not exceed the annuity's income on the contract (*i.e.*, it is taxed on an income-first basis).

Loans, assignments and dividends. The income-first tax treatment that applies to actual partial distributions from annuity contracts also applies to other types of amounts that provisions of the Code deem to be distributions. In particular, if an individual receives (directly or indirectly) any amount as a loan under an annuity contract, or assigns or pledges (or agrees to assign or pledge) any portion of the value of the contract, such amount or portion is treated as received under the contract as an amount not received as an annuity.[21] Furthermore, policyholder dividends are generally treated as amounts not received as an annuity, unless they are retained by the insurer as premiums or other consideration paid for the contract.[22] With regard to loans and dividends, the portion of the amount treated as received under the contract that is subject to the income-first rule will be includible in gross income, and as a result—again assuming the broader reading of the term "annuities"—that amount will be included in net investment income for Investment Income Tax purposes.

The exclusion ratio operates to treat part of each annuity payment received as returning a portion of the contract holder's investment in the contract. …

Complete dispositions and transfers. Any amount that is "not received as an annuity" and is received under an annuity contract either i) on the contract's complete surrender, redemption or maturity, or ii) in full discharge of the obligation under the contract and which is in the nature of a refund (whether paid in a single sum or otherwise), is includible in gross income to the extent that it exceeds the investment in the contract.[23] Further, if an individual transfers an annuity contract without full and adequate consideration (*i.e.*, a gratuitous transfer), the taxpayer must include in gross income the excess of the cash surrender value of the contract at the time of transfer over the investment in the contract at that time under the contract.[24] In each of these transactions, to the extent an amount is included in gross income pursuant to section 72, that amount presumably is included in net investment income for Investment Income Tax purposes under the broader reading of "annuities." Finally, in the case of an annuity contract that is transferred for valuable consideration (*i.e.*, a sale), gain is recognized under section 1001. While such gain may not be

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income from "annuities," it probably is encompassed within "net gain from dispositions of property," and on that basis it would be treated as net investment income for purposes of the new tax.

Annuity distributions not subject to new tax. Certain distributions from annuity contracts are not subject to the Investment Income Tax. As noted above, policyholder dividends retained by the insurer as premiums or other consideration paid for an annuity contract are not includible in gross income and, thus, are not subject to the new tax. Another instance of distributions from annuity contracts that are not included in gross income, and therefore are excluded from the Investment Income Tax, is that of amounts used to fund qualified long-term care insurance riders to annuity (and life insurance) contracts.[25]

One other category of income from annuity contracts that may not be subject to the new tax—the matter is not clear—is income described in section 72(u). That provision treats the inside buildup of an annuity contract held by a nonnatural person (*e.g.*, a corporation, partnership or trust) as currently includible in gross income, unless that person is holding the contract as an agent for one or more natural persons. Section 72(u) expressly declares that the contract held by a nonnatural person is not treated as an annuity for income tax purposes (except under subchapter L, the rules governing insurance company taxation). Hence, it would not seem logical to view the deemed income from such a contract as income from "annuities." That said, given the treatment of the contract prescribed by section 72(u), it is possible that the deemed income could fall under another category of receipt that makes up net investment income under the Investment Income Tax.

Qualified Plans

The definition of net investment income under the Investment Income Tax expressly excludes distributions from tax-qualified retirement plans, including IRA annuities. Specifically, section 1411(c)(5) provides that "net investment income" does not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Thus, distributions from an annuity contract that is an IRA, a section 403(b) annuity, or otherwise held as part of a tax-qualified retirement arrangement are not subject to the new tax, regardless of whether such distributions are periodic or nonperiodic. Presumably, however, such distributions (to the extent they are otherwise includible in gross income) are taken into account in determining whether a taxpayer has reached the income thresholds described above.[26] In that case, it might be advisable for an IRA annuity owner to examine the manner in which he or she will take the first required minimum distribution ("RMD").[27] More specifically, an IRA owner has until April 1 of the year following the year in which he or she turns age 70½ to take the first RMD, although the IRA owner must also take the second RMD for that year by December 31 of that same year. Depending on the IRA owner's income, two RMD payments in one year could cause that income to exceed the applicable income threshold. To avoid such a result, an IRA owner may want to take the first RMD in the year he or she turns age 70½ and not delay that distribution to the following year.

Life Insurance Contracts

While it is clear that the Investment Income Tax potentially applies to income from annuity payments, and it is possible that the tax also applies to other types of income from annuity contracts, it is less clear whether or how the new tax will apply to transactions involving life insurance contracts. The legislative history of the Act is silent on this point, and as noted above, section 61(a) distinguishes income from "annuities," referenced in paragraph 9 of the provision, from "income from life insurance and endowment contracts," referenced in paragraph 10. While the definition of net investment income under new section 1411 expressly includes annuities, it does not refer to income from life insurance or endowment contracts. On the other hand, in limited instances the term "annuities" has been defined or interpreted to include life insurance.[28] Section 1411 does, of course, include net gain from dispositions of property in net investment income for Investment Income Tax purposes.

In this regard, section 61(a)(3) generally treats gain from the disposition of property as includible in gross income, and sections 1001 *et seq.* specifically govern the tax treatment of such a disposition. In the case of a sale of a life insurance contract (*e.g.*, through a life settlement), it seems straightforward that income from such a sale is included in "net gains from the disposition of property" for Investment Income Tax purposes, for the simple reason that section 1001 applies to such a transaction.[29] In contrast, the disposition-of-property rule would not seem appropriately interpreted as including income from the surrender of a life insurance contract. The full or partial surrender of a life insurance contract generally is not treated as a disposition of property, in that such a transaction is governed by section 72 rather than by section 1001,[30] and nothing

in the Act's language or legislative history expressly indicates the adoption of such an interpretation. Even so, absent guidance in the legislative history, there remains uncertainty as to how, if at all, the Investment Income Tax applies to transactions involving life insurance contracts.

IMPACT IN THE MARKETPLACE

It will likely take some time before the effect of the new Investment Income Tax on the annuity marketplace is fully known. That said, several observations may be in order. First of all, the Act defines "net investment income" such that the phrase includes annuity payments (and maybe other distributions) from nonqualified annuity contracts along with dividends, interest, and net capital gains recognized in connection with mutual funds and individual stocks and bonds. Thus, one might think of the Act as imposing, for high income taxpayers, the same increase in the marginal income tax rate on annuity contract distributions as is imposed on dividends, interest, and net capital gains. To the extent that tax rates on annuity distributions and other types of investment income are being increased equally, the tax deferral provided by annuity contracts would appear relatively more attractive.

A second observation would be that a taxpayer seemingly would want to maximize the contributions to his or her qualified retirement plan, including an IRA annuity or Roth IRA annuity, instead of saving through other investment vehicles such as mutual funds. As described above, amounts distributed out of qualified retirement arrangements are not subject to the Investment Income Tax. Furthermore, the fact that Roth IRA distributions are not taken into account in determining whether a taxpayer exceeds the applicable income thresholds makes a Roth IRA one of the most advantageous products a taxpayer can invest in to minimize the application of the Investment Income Tax. High income taxpayers have been restricted in past years in the contributions they could make to qualified retirement plans, including IRAs, but to the extent such contributions have been made, the opportunity during 2010 to convert amounts to Roth IRAs regardless of income levels could provide additional benefit where the Investment Income Tax is concerned.

Third, and cutting in the opposite direction, it must be acknowledged that an increase in tax on annuity distributions will necessarily increase the "cost" of annuities for high income annuity owners. As a practical matter, however, this effect may be felt in relatively few households. A recent survey found that eight out of 10 nonqualified annuity owners have annual household incomes below $100,000, and only 4 percent have annual household incomes greater than $200,000.[31] The results of this survey indicate that many annuity owners would not have income in excess of the applicable thresholds and, thus, the new Investment Income Tax would not apply to annuity distributions received by them.

Finally, it may well be significant that the new Investment Income Tax is not effective until Jan. 1, 2013. This delay in the imposition of the tax gives the issuers and sellers of annuity contracts, along with the financial advisers of current and potential annuity owners, in excess of two years to work out sound strategies for addressing the impact of the new tax on retirement savings. ◂

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END NOTES

1. Pub. L. No. 111-148.
2. Pub. L. No. 111-152.
3. Technically, the new 3.8% tax is labeled the "Unearned Income Medicare Contribution."
4. Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
5. A similar tax is imposed on estates and trusts. *See* section 1411(a)(2).
6. Section 1411(a)(1).
7. Section 1411(b)(1).
8. Section 1411(b)(2).
9. Section 1411(b)(3).
10. *See* section 62.
11. Section 1411(d).
12. *But see* the discussion of section 72(u) below.
13. Section 61(a)(9).
14. Section 61(a)(10).
15. Section 61(a)(3).
16. Treas. Reg. § 1.61-1(b).
17. *See* Treas. Reg. § 1.72-4(b)(1) (defining the annuity starting date as generally being the later of the date upon which the obligations under the contract became fixed or the first day of the period which ends on the date of the first annuity payment).
18. The relevant legislative history of the tax changes made by the Act appears in the *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act"* prepared by the Staff of the Joint Committee on Taxation (JCX-18-10, March 21, 2010). The Investment Income Tax is described on pages 134-136 of the document.
19. *See, e.g.,* section 3405(e)(1)(A) (treating any distribution from or under a commercial annuity as a designated distribution, which can be either a periodic payment (such as an annuity payment) or a nonperiodic distribution.
20. Section 72(e)(3) provides the rules for allocating amounts received before the annuity starting date to the income on the contract and to the investment in the contract.
21. Section 72(e)(4)(A).
22. *See* sections 72(e)(1)(B) and 72(e)(4)(B).
23. Section 72(e)(5)(E).
24. Section 72(e)(4)(C). Certain transfers between spouses or former spouses to which section 1041(a) applies (relating to transfers of property between spouses or incident to divorce) are not subject to this rule.
25. *See* section 72(e)(11).

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END NOTES (CONTINUED FROM PAGE 21)

[26] It appears that qualified distributions from Roth IRAs within the meaning of section 408A(d)(2) are not included in the taxpayer's income and therefore do not affect the taxpayer's income for purposes of determining whether the taxpayer exceeds the applicable income threshold under section 1411(b).

[27] *See* section 408(a)(6) and (b)(3) (requiring IRA owners to begin minimum distributions in accordance with the rules under section 401(a)(9) once they reach age 70½).

[28] *See, e.g.*, section 3405(e)(6) (defining a "commercial annuity" as an annuity, endowment or life insurance contract issued by an insurance company licensed to do business under the laws of any State); Treas. Reg. § 1.1244(c)-1(d)(vi) (providing that the term "annuities" means the entire amount received as an annuity under an annuity, endowment or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72).

[29] *See* Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (holding that sections 1001, 1011 and 1012 apply in determining the amount a taxpayer must recognize in gross income upon the sale of a life insurance contract).

[30] *See* section 72(e)(5)(E); Rev. Rul. 2009-13 (confirming that section 72 applies to amounts received under a life insurance contract, which would include amounts received upon complete surrender, redemption or maturity as well as partial withdrawals and policyholder dividends paid in cash).

[31] The Committee of Annuity Insurers, Survey of Owners of Non-Qualified Annuity Contracts (The Gallup Organization and Mathew Greenwald & Associates, 2009).

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ATTORNEY—ACTUARY DIALOGUE ON NOTICE 2010-29

By Peter Winslow and Christian DesRochers

On March 25, 2010, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued Notice 2010-29. The new Notice follows-up Notice 2008-18, in which the Treasury and the IRS identified concerns regarding proposed Actuarial Guideline VACARVM and suggested approaches that might be taken to address those issues. Actuarial Guideline VACARVM was effective, as AG43, beginning on Dec. 31, 2009. In response, the Treasury and the IRS issued Notice 2010-29 providing interim guidance on company tax issues related to AG 43. This discussion is the fourth in a continuing series of interdisciplinary dialogues in *Taxing Times* on selected tax issues related to proposals regarding principle-based reserves. This dialogue features Peter Winslow, a tax attorney, and Christian DesRochers, a tax actuary and current chair of the Society of Actuaries Taxation Section.

Peter: Chris, on April 21, Mark Smith [Treasury], you and I did a webinar discussing Notice 2010-29. After saying the usual caveats that his views are solely his and not necessarily those of the IRS or Treasury, Mark summarized four key points at the beginning of the session.

First, Mark said that the Notice is in the nature of a safe harbor. It does not represent a final determination of the IRS's or Treasury's legal conclusions, but it does provide audit protection for taxpayers until further guidance is issued. Mark's second point was that no inference should be drawn from the Notice as to IRS/Treasury position on any other issue. Third, Mark said that there are no subtle messages in the Background section of the Notice; it was intended to be a straightforward recitation of existing law, breaking no new ground. Finally, Mark said that no request for comments was made because IRS/Treasury would like to monitor the impact of the Notice for a time before deciding whether changes to the interim guidance are warranted.

With these comments in mind, Chris, can you generalize about the industry's reaction to the Notice?

Chris: Mark and Sheryl Flum of the IRS also participated in a panel discussion sponsored by the Taxation Section at the Society of Actuaries' Life and Annuity Symposium in Tampa in which they echoed the comments you noted above. Their willingness to discuss the Notice is much appreciated and very helpful in creating a dialogue between IRS and Treasury and the industry. As to the Notice itself, the reaction has been positive, although as we will discuss, some issues remain unresolved. We all understand that as the industry gains more experience with AG 43, additional issues are likely to arise, but the Notice seems to have accomplished its goal of providing timely guidance to enable companies to file their tax returns for 2009.

Peter, to begin our discussion of the substance of Notice 2009-19, a good starting point is Notice 2008-18, in which the Treasury and the IRS raised issues related to the transition to VACARVM, or AG 43, as it was ultimately adopted by the National Association of Insurance Commissioners (NAIC). With respect to qualification as a life insurance company under section 816(b), they expressed the view that it was preferable for life insurance companies to continue to be taxed under Part 1 of Subchapter L. *i.e.,* as life insurance companies, so that the enactment of AG 43 should not affect the status of a company as a life insurance company. One of the approaches suggested in Notice 2008-18 was to "require the use of only the standard scenario amount (in the case of Proposed AG VACARVM.)" Notice 2010-29 includes the Standard Scenario Amount (SSA) in both life insurance reserves and total reserves under the qualification test, but provided no comment on the treatment of the Conditional Tail Expectation (CTE) amount. While recognizing the SSA as a part of life insurance and total reserves, Notice 2010-29 does not include the limitation to "require the use of only the standard scenario amount." Do you see any significance in the position in Notice 2010-29?

Peter: I think the Notice's silence on the proper characterization of the CTE amount is very significant, but not for

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section 816(b) purposes. Your question specifically relates to whether the CTE amount is a life insurance reserve or an insurance reserve to be included in numerator and/or denominator of the 50-percent reserve ratio test in section 816(b) for purposes of determining qualification as a life insurance company. Resolution of this issue standing alone is not particularly important because tax status is unlikely to change regardless of how the CTE amount is treated in the reserve ratio test. Remember, under AG 43 the CTE amount is only the excess over the SSA. But, whether the CTE amount qualifies as a life insurance reserve or an insurance reserve can be very important for other reasons, particularly with respect to the question of whether the CTE amount should be included in the statutory reserves cap. So, let's turn to that issue.

Section 3.02 of Notice 2010-29 concludes that the SSA is included in the statutory reserves cap, but, as in the case of the reserves ratio test, the Notice is silent as to whether the CTE amount also is included. This is potentially an important issue for contracts issued prior to Dec. 31, 2009, which will have tax reserves on a different basis than statutory reserves. Chris, do you have any thoughts about this issue?

Chris: I am optimistic that at this point the Treasury and IRS have an open mind on the treatment of the CTE amount, at least with respect to qualification and the statutory cap. With respect to the 50-percent reserve ratio test, I agree with your observation that the Treasury and IRS are well aware that exclusion of the CTE amount is not likely to cause any life insurance company to lose qualification as a life company. Thus, their silence on the issue was a pragmatic solution that allowed the Notice to be issued, without the need to address the nature of the CTE amount. In that regard, while the CTE amount has elements that are consistent with the section 816 definition of life insurance reserves *(i.e.*, are set aside to mature or liquidate future unaccrued claims involving life, accident or health contingencies), there are also elements in the CTE amount that cause the Treasury and IRS concern about their inclusion as components of life insurance reserves.

However, with respect to the statutory cap, there doesn't seem to be a compelling argument against the inclusion of any CTE amount in excess of the SSA in the statutory cap. As a practical matter, for those companies with reserves based on the CTE amounts, it seems a reasonable position to include them in the statutory cap, but each company must decide that for themselves. Peter, I know you have a view on the CTE amounts and the statutory cap. Can you share it with our readers?

Peter: The question as to the meaning of "statutory reserves" under section 807(d)(6) for purposes of the tax reserves cap is currently being considered by the IRS National Office in the context of deficiency reserves, and no decision has been made. As a technical matter, statutory reserves are defined in the Code as liabilities held "with respect to" insurance reserves described in section 807(c), implying that "statutory reserves" is a broader concept than just deductible tax reserves. But, the definition also implies that there must be a nexus between the statutory liability and section 807(c). In my view, the fact that the excess CTE amount has been defined by the NAIC to be part of CARVM should satisfy the nexus requirement. This conclusion is supported by the legislative history. The concept of "statutory reserves" was intended to be broadly construed to be consistent with the policy of former section 809 to increase mutual companies equity base and of section 807 to ensure that all taxpayers obtain the same reserve deduction as long as they hold statutory reserves for the policy at least equal to the federally prescribed reserves. So, I think the better answer is that the excess CTE amount should be included in the statutory reserves cap, but the IRS National Office has not made this determination, and, as I said, whatever it concludes on the deficiency reserve issue may have a bearing on the outcome here.

Chris, you mentioned some IRS concerns with new factors taken into account in the CTE amount. Are there similar concerns with the SSA?

Chris: Section 3.03 of the Notice provides that "for purposes of determining the amount of the reserve under section 807(d)(2) with respect to a contract falling within the scope of AG 43 and issued on or after Dec. 31, 2009, the provisions for determining the Standard Scenario Amount are taken into account, and the provisions for determining the CTE amount are not taken into account." One effect of the Notice is that it provides a clear safe harbor for the SSA as the federally prescribed reserve. The recognition of the SSA as the basis for the federally prescribed reserve is one of the very positive aspects of the Notice, as there are components of the SSA that could have been problematic, although for different reasons. First, the Accumulated Net Revenue element of the SSA covers more than just assumed interest and mortality, but also contains account drop and recovery assumptions, as well as

projections of assumed lapses and partial withdrawals. While there is precedent for recognition of factors other than mortality and interest in the calculation of life insurance reserves,[1] the treatment of the drop assumption under AG 34 has been an issue in the CIGNA case. Second, the recognition of value of hedges in the SSA, while not creating a particular reserve issue, seems to me to require that a company should think about how it might affect their tax accounting for hedges generally. Peter, any thoughts on either of these issues?

Peter: As to the SSA, I agree that it is comforting to know that the nonmortality and interest aspects of AG 43, such as consideration of lapses, reinsurance, hedging, account value drop assumptions and margins, will be accepted without a need to carve out portions of the reserves or adjust these assumptions. But, I also think it is important to caution our readers that in our webinar, Mark Smith reiterated that the Notice is only an interim safe harbor with no inference to be drawn on these issues for prior years' audit issues or for future guidance having prospective affect.

As to the CTE amount that will not qualify as part of the federally prescribed reserve, the Notice does not explain the rationale for the disqualification. I think there could be at least four possible rationales. The CTE amount could be considered at least in part, a "surplus" reserve and not an insurance reserve. Second, it could be considered to fail, as a "life insurance reserve" and such qualification may be considered a prerequisite to a deduction under section 807(d). Third, the Notice could be saying that the CTE amount is not a deterministic reserve and only this type of reserve can qualify for a deduction under section 807(d). Or, fourth, it could be that the CTE amount is not capable of being recomputed under section 807(d) in a manner that yields an appropriate tax reserve amount. The rationale for the disqualification matters, for example, to the conclusion as to whether the CTE amount is included in the statutory reserves cap and as to how principle-based reserves will be treated. I personally disagreed with the first three potential rationales and hope that the fourth rationale was the theory relied upon to conclude that the excess CTE amount is not part of federally prescribed reserves.

Turning to hedging, my initial reaction is that it is the adoption of AG 43 generally that probably will have the greater impact on tax accounting for related hedges, rather than the treatment of hedges in the AG 43 formula itself. But, this question raises very complicated issues well beyond what we are here to discuss today.

Chris, tell us about the Notice's discussion of the effective date of AG 43 for tax purposes.

Chris: The application of AG 43 differs with respect to contracts that it covers for statutory and tax purposes. For statutory reserves, AG 43 affects all contracts issued on or after Jan. 1, 1981, effective as of Dec. 31, 2009. However, where the application of AG 43 produces higher reserves than the prior method, an insurer may request a permitted practice for a grade-in period of three years. For tax reserves, Notice 2010-29 applies AG 43 to "taxable years ending on or after Dec. 31, 2009" for purposes of Section 3.01 Reserve Ratio Test and 3.02 Statutory Reserve Cap. In determining the amount of the reserve under section 807(d)(2), Notice 2010-29 applies different rules based on a contract's issue date, as follows: a) for a contract issued before Dec. 31, 2009, the tax reserve method is "the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43:" and b) for a contract "falling within the scope of AG 43 and issued on or after Dec. 31, 2009," the tax reserve method is the method prescribed in AG 43 as adjusted by the Notice.

The CTE amount could be considered at least in part, a "surplus" reserve and not an insurance reserve. Second, it could be considered to fail, as a "life insurance reserve." …

The Notice is based on the IRS and Treasury view of section 807(d)(3)(A)(ii) which sets the tax reserve method as "CARVM in the case of a contract covered by the CARVM," while section 807(d)(3)(B)(ii) in turn defines CARVM as "the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract." The view implicit in Notice 2010-29, as well as other IRS guidance, is that actuarial guidelines, including AG 43, are effective for tax reserves prospectively for new issues even though as in the case of AG 43 the guideline itself applies retroactively to both in force and new issues. This creates a situation in which statutory and tax reserves are in some cases computed in significantly different ways. This would particularly be the case for variable annuity living benefits (VAGLBs) if the tax reserve method for contracts issued before Dec. 31, 2009, is based on AG 39, in which reserves are computed as an accumulation of fees. As a result,

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there are now instances where the statutory reserve under AG 43 exceeds the tax reserve and other cases in which the AG 43 reserve may be less than the tax reserve, resulting in statutory capping. This is an important reason that the treatment of the statutory cap has emerged as a significant issue under AG 43.

Peter, the effective date of actuarial guidelines was one of the issues in the recent American Financial case, which is discussed in another article in this issue of *Taxing Times*. There are also people who believe that that AG 39 was an interim guideline that was never intended by the NAIC to create a permanent reserve method. The argument is that AG 39 sunsets as of Dec. 31, 2009, so it is no longer a proper interpretation of "the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract" and is therefore no longer the appropriate tax reserve method for policies issued before Dec. 31, 2009. Do you think that view has any merit?

Peter: I do. In several audits of returns for pre-AG 43 tax years, IRS agents have taken the position that AG 39 is not CARVM for tax reserve purposes because it does not seem to conform with CARVM methodology as set forth in the Standard Valuation Law and because nowhere in the text of AG 39 is there a reference to CARVM. The IRS's current audit position is stronger now that AG 39 has expired. Is a reserve measured by undiscounted accumulated charges for the duration of the contract really the NAIC-prescribed CARVM after 2009? If neither AG 43 nor AG 39 is CARVM for pre-AG 43 contracts, what is? The answer probably is AG 33, but that guidance does not tell us specifically how to compute reserves with guaranteed living benefits. The legislative history of the 1984 Act tells us that, in general, we are supposed to compute the federally prescribed reserve by starting with the statutory reserve and making the adjustments required by section 807(d). Therefore, I think the correct approach probably is to start with the SSA under AG 43 and retain the methodology and assumptions that are not inconsistent with CARVM (as interpreted by AG 33) as of the date the contract was originally issued. Other AG 43 assumptions that are new would have to be modified. These may include such things as the treatment of lapses, partial withdrawals, hedging, reinsurance, continuous functions, and maybe other items I have not thought about. Another way to state this is that for contracts issued before the tax effective date of AG 43 the federally prescribed reserves may equal AG 33-type reserves computed using the same assumptions used for the SSA statutory reserves except to the extent AG 43 assumptions would not have been permitted by the NAIC, or a majority of states, or considered an appropriate interpretation of the Standard Valuation Law at the time the contract was issued. By the way, it is likely that this AG 33-type tax reserve would be greater than AG 43 statutory reserves and, therefore, the tax reserves would be capped.

Chris: Peter, it is interesting to note that section 3.03 of the Notice speaks in terms of "relevant actuarial guidance in effect before the adoption of AG 43" in the context of the federally prescribed reserves, but does not specify what the relevant guidance actually is. As a consequence, Notice 2010-29 certainly does not preclude the approach that you have described above. This is a topic that should continue to receive some additional discussion as companies develop positions relative to their tax reserves on pre-Dec. 31, 2009 issues.

Now, I'd like to turn to section 3.04 of the Notice which provides that any difference in the amount of tax reserves "determined with regard to AG 43 and the amount determined without regard to AG 43 (*i.e.,* under prior actuarial guidelines) must be spread over 10 taxable years, using the method prescribed by section 807(f)(1)(B)." In discussions, Mark Smith cautioned that the term "the method prescribed by section 807(f)(1)(B)" should be read carefully, as it did not reflect the position that section 807(f)(1)(B) specifically applied to the change in tax reserves resulting from AG 43, but that any change should be spread over 10 years. This seems to be a practical approach to dealing with a change in reserves on business issued before Dec. 31, 2009. Reserves under AG 43 vary by company, depending on the types of products sold, and the time period in which they were sold. For some companies, reserves increased, while for others reserves declined as a result of AG 43. Without guidance, the IRS appears to have been concerned that companies whose reserves increased would take the deduction immediately, while companies whose reserves decreased would spread the income over 10 years. However, they did not seem to bring the change under section 807(f)(1)(B) specifically, perhaps because most commentators do not view a change in the statutory cap as a change in reserve basis which is subject to a 10-year spread.

Peter: Before we wind down, I would like to address one point made by Mark Smith in our webinar. He said that even

though the Notice does not necessarily reflect the final views of the IRS or Treasury, complete reliance can be placed on the Notice until further guidance is issued. If this is really the intent, it is important that the safe harbor protection be interpreted to mean that tax reserves for contracts are locked in place forever and that the protection not be limited to taxable years prior to any changes. Otherwise, there could be no true protection that could be relied upon for pricing purposes.

Also, although the Notice does not ask for comments, the IRS and Treasury have encouraged further comments particularly on the nature of the CTE amount, because they would like to better understand how the CTE amount is driven by the various factors taken into account in the computation.

Chris, I know that the Notice says that its conclusions should not have any precedential effect, but are there any lessons to be learned as we go forward on PBR? Any other final thoughts?

Chris: As I noted at the outset, overall the industry reaction to the Notice has been positive, although as we have discussed, there are questions that remain to be answered. The IRS and Treasury appear to have gone as far as they feel comfortable in accommodating changing statutory reserve requirements. I'd like to think this is in part a result of communication between industry and government, including the previous dialogues that have been presented in *Taxing Times*. I also believe that there has been a great effort made to arrive at the "right answer" within the limitations of the Internal Revenue Code. As we move forward in the development of principle-based reserves for life insurance, the comments of IRS and Treasury in both Notice 2008-18 and 2010-29 are generally helpful, but also contain a warning. They are positive in the sense that the IRS and Treasury appear to be willing to accept a broad definition of life insurance reserves, including elements other than strictly interest and mortality. At the same time, the discussions of the factors included in CTE amount indicate a view that there may be limits to what can be in a deductible life insurance reserve. That is, the definition of federally prescribed reserve under current law can only be stretched so far, and efforts to make life principle-based reserves more "tax friendly" continue to be important.

One of the frustrations that Mark Smith expressed relative to the process of developing Notice 2010-29 was the lack of data that was available to IRS and Treasury relative to the effect of AG 43. I believe this reflected the difficulty of implementing AG 43, and the timing of system changes needed to bring the calculations on line. If additional discussions are going to occur relative to the makeup of the CTE amount, and its resulting tax treatment, access to data will be a key element for IRS and Treasury to come to a decision.

Peter, on behalf of the Taxation Section, I'd like to thank you for participating in the webinar, as well as your willingness to engage in yet another dialogue. Your insights are much appreciated. There are a number of issues that we have addressed that should generate additional discussions. Any of our readers that have thoughts or comments are welcome to share them with us. We hope to hear from some of you.

END NOTES

[1] *See*, for example, Union Mutual Life Insurance Company v. United States of America, 570 F.2d 382, 397 (1st Cir. 1978) and Mutual Benefit Life Insurance Company v. Commissioner, 58 T.C. 679, 688 (3d Cir. 1972), 488 F.2d 1101, 1107 *See also* Lincoln National Life v. United States, 217 Ct. Cl. 515, 585 F.2d 579 (1978).

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SSAP 10R—ADMITTANCE OF DEFERRED INCOME TAXES MODIFIED IN 2009

By Thomas Barber and Kelly Brucato

On Dec. 7, 2009, a revised version of the admitted deferred tax asset ("DTA") guidance emerged when, after careful consideration and much debate, the National Association of Insurance Commissioners ("NAIC") passed Statement of Statutory Accounting Principles No. 10R, *Income Taxes - Revised, A Temporary Replacement of SSAP No. 10* ("SSAP 10R") in a 33-22 vote.

SSAP 10R supersedes Statement of Statutory Accounting Principles No. 10, *Income Taxes* ("SSAP 10") and the new provisions set forth in this accounting principle are effective for year-end 2009 statutory financial statements. If elected, they provide, where appropriate, the ability to admit additional DTAs by increasing the projected realization period from one to three years along with increasing the statutory surplus limitation from 10 percent to 15 percent, provided the entity exceeds certain risk based capital ("RBC") thresholds. SSAP 10R also makes explicit and gives definition to the implicit valuation allowance of SSAP 10,[1] and increases transparency through its expanded disclosure requirements for all entities (regardless of whether electing the expanded recognition provisions).

HISTORICAL BACKGROUND: STATUTORY DEFERRED INCOME TAX

Statutory deferred income tax accounting has been around for a relatively short period of time compared to generally accepted accounting principles ("GAAP"). Effective Jan. 1, 2001, statutory deferred income taxes were introduced with the adoption of SSAP 10.[2] In contrast, the deferred income tax concept for GAAP accounting was first introduced in 1967 and has gone through a number of changes over the years to get to the current rules within Accounting Standards Codification ("ASC") topic 740, "*Income Taxes*" (ASC 740).[3]

In general, SSAP 10 follows the main principles of FAS 109 regarding the measurement of deferred income taxes. Generally, DTAs and deferred tax liabilities ("DTLs") are the result of a difference between the tax basis of an asset or a liability and its corresponding basis in the statement of financial position if that difference will result in taxable or deductible amounts in some future year(s). However, differences between SSAP 10 and FAS 109 exist. One major difference is the methodology of determining the amount of the DTAs that will be recognized. FAS 109 requires a valuation allowance for reducing gross DTAs if it is *more likely than not* that some or all of the DTAs will not be realized in the future, which is determined through a qualitative review. On the other hand, SSAP 10 primarily employs an admitted asset test for restricting gross DTAs, which is mechanical in nature.

The SSAP 10 admittance test attempts to follow the general rules within statutory accounting principles, whereby assets are not admitted on the balance sheet if they have "economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet…".[4] However, under SSAP 10, DTAs are generally subject to a double restriction on admissibility; a one-year reversal test while also being subject to a possible limitation based upon 10 percent of statutory surplus. While the replacement of the FAS 109 valuation allowance concept with the realization criteria employed in the DTA admittance tests is intended to ensure that an entity's surplus is conservatively measured,[5] many professionals feel that the rules for recognizing gross DTAs under SSAP 10 are overly conservative.

SSAP 10R—IN GENERAL

SSAP 10R, as passed by the NAIC, makes a number of significant changes to the provisions for deferred income taxes. Among the changes is an explicit valuation allowance concept, consistent with FAS 109, to be applied to gross DTAs before the admitted asset test is applied, and an election to expand the admitted asset test if certain RBC thresholds are met. In addition, the provisions include additional emphasis on the character of income (ordinary vs. capital) both as to admittance and in the disclosure. The new provisions of SSAP 10R became effective as of Dec. 31, 2009. Any change in admitted DTAs due to the new provisions of SSAP 10R is considered a change in accounting principle effective Dec. 31, 2009.

SSAP 10R is a temporary replacement of SSAP 10 as SSAP 10R expires after 2010. If no additional guidance is adopted by the end of 2010, SSAP 10 will be reinstated effective Jan. 1, 2011. The NAIC's Statutory Accounting Principles Working Group ("SAPWG") announced, in the spring of 2010, the formation of the DTA Subgroup whose goal it is to have a long-term solution on the accounting for deferred income taxes and admissibility for the first quarter of 2011 since SSAP 10R sunsets at the end of 2010.

VALUATION ALLOWANCE CONCEPT

One of the changes included in SSAP 10R is the addition of an explicit valuation allowance concept. This provision requires a reduction of an entity's gross DTAs if it is *more likely than not* (greater than 50 percent chance) that some portion (or all) of the gross DTAs will not be realized (the reduced amount is a new term referred to as the "adjusted gross deferred tax asset"). The statutory valuation allowance is determined in accordance with FAS 109, paragraphs 20-25 and will have to be evaluated on a company-by-company basis. Future realization of the tax benefit depends on the existence of sufficient taxable income, of the appropriate character (ordinary income vs. capital gain), within the applicable tax law carry-forward period.[6]

There are additional factors to consider in determining whether a statutory valuation allowance is needed, including tax planning strategies; the expected emergence of future earnings; and other various future events. SSAP 10R also requires that both negative and positive evidence be considered in determining whether a valuation allowance is needed; similar to FAS 109. Once a valuation allowance methodology is developed, the methodology needs to be applied on a consistent basis.

EXPANDED ADMITTANCE TEST

The "adjusted gross DTA" is used as the starting point for the admissibility test under SSAP 10R. Thus, instead of using the total gross DTAs, the admissibility test under SSAP 10R paragraphs 10a, 10b and 10c and new paragraph 10e is applied against the "adjusted gross DTA." New paragraph 10e expands the realization period over which DTAs are projected to be realized to better match the IRS loss carry-back rules; not exceeding three years. The expanded rules are elective, and only apply to companies who are subject to the RBC rules or who are required to file an RBC report with their state of domicile.[7] A company may use the expanded admittance rules only if their RBC level, determined after computing the admitted DTA's under paragraph 10a through 10c, is above the maximum RBC level where an action level could occur (250 percent for life and fraternal entities; 300 percent for property/casualty ("P&C") entities and health entities), or, for companies subject to a RBC trend test, where the RBC level exceeds the RBC trend test. As a result, this election could produce potential volatility in results and may reduce comparability within the industry. Accordingly, the additional DTA admitted as a result of this election will be reflected separately in the financial statement (*see* below).

Admittance Test under SSAP 10

By way of background, the admitted asset test under SSAP 10 determines the admissible DTA as the sum of items identified in paragraphs 10a-c:

10a) 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 (one year reversal).

10b) The lesser of:

- i) The amount of remaining adjusted gross DTAs, after the 10a test., expected to be realized within one year of the balance sheet date (one year reversal) or
- ii) Ten percent of adjusted statutory capital [as adjusted – *e.g.,* removing DTAs, goodwill] and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement (annual or quarterly);

10c) The amount of remaining adjusted gross DTAs, after the 10a and 10b tests that can be offset against existing gross DTLs.

If elected, the expansion under 10e allows for additional admissibility of DTAs by:

10e.i) Increasing the ability to admit DTAs by means of a deemed loss carryback of reversing temporary differences from one year (paragraph 10a) to the number of years the IRS permits a carryback, not to exceed three years. Thus life insurers can uti-

CONTINUED ON PAGE 30

lize a three-year reversal timeframe while nonlife insurers are limited to a two year-reversal period. Note that any potential future increases in loss carrybacks similar to the recent special five-year carryback provisions, would only benefit nonlife insurers.

10e.ii(a) Extending the reversal of temporary difference period from one year (paragraph 10.b.i) to three years in the future realization test, and

10e.ii(b) Increasing the surplus limitation from 10 percent (paragraph 10.b.ii) to 15 percent.

The admitted DTA calculated under the new 10e test (after taking into account the valuation allowance) is then compared with the aggregate admitted DTAs allowed under revised paragraphs 10a, 10b and 10c (after taking into account the valuation allowance). Any excess of 10e over the sum of revised paragraphs 10a through 10c admitted DTAs is reported separately on the face of the statutory financial statement as follows:

1. *Aggregate write-ins for gains and losses in surplus* in the change in Capital and Surplus Account (beginning in 2010), and
2. *Aggregate write-in for special surplus funds* on the Balance Sheet

For life companies, there is also a 5 percent RBC charge on the additional admitted DTA permitted by SSAP 10R under paragraph 10.e. These reporting changes were adopted as a temporary measure for year-end 2009 only.

The calculation of the expanded admitted DTA under new paragraph 10e is detailed and creates significant additional reporting requirements. In addition, the extension of the reversal patterns to three years also expands the need to develop consistent forecasts of taxable income for three years. If a company qualifies and elects to utilize the additional admittance available under 10e, the RBC calculation will, for the first time, require auditor review.

RISK BASED CAPITAL

At the request of the SAPWG, the NAIC's Capital Adequacy Task Force reviewed whether a RBC charge for any additional admittance of deferred taxes under SSAP 10R was appropriate. Two proposals were drafted and adopted during the Dec. 17, 2009 conference call of the Capital Adequacy Task Force: 1) an additional DTA sensitivity test and 2) a DTA charge to life companies RBC. The NAIC's proposed sensitivity test calculation removes the impact of the expanded admitted DTA from the RBC calculation in determining whether an insurance company has met the 300 percent P&C and 250 percent life RBC ratio in SSAP 10R. [Further, the NAIC has proposed that for life insurance companies, the admitted DTA will have a 1 percent RBC charge. Currently, the P&C RBC formula contains a 5 percent charge [before covariance – more like 1 percent], which at this point would also apply to the expanded admitted DTA. For life companies, there is also a 5 percent RBC charge on the additional admitted DTA permitted by SSAP 10R under paragraph 10.e. These reporting changes were adopted as a temporary measure for year-end 2009 only.

CONSIDERATION OF CHARACTER: ORDINARY VS. CAPITAL

The new provisions under SSAP 10R reinforce that the income character of DTAs and DTLs (*i.e.,* ordinary vs. capital) must be considered when applying the admissibility test of SSAP 10R. SSAP 10R, paragraphs 10.c and 10e.iii states that offsetting adjusted gross DTAs with existing gross DTLs will be permitted only to the extent that "offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations." While the character of income items was already a factor required to be considered for admitting DTAs under SSAP 10 (*see* SSAP 10 Q&As 4.4 and 4.7), the new provisions emphasize this point. This character emphasis also pertains to the additional disclosure requirements (discussed below).

CHANGE IN ACCOUNTING PRINCIPLE

Revisions to the admitted DTA as a result of implementation of SSAP 10R are considered a change in accounting principle effective Dec. 31, 2009. Given that SSAP 10R is effective as of Dec. 31, 2009 any company admitting any additional DTAs as a result will have to perform both the SSAP 10 and the SSAP 10R admissibility tests to determine the amount to be reported as a change in accounting principle. This amount is reflected in the statutory annual statement in changes in Capital and Surplus Account in the line *Cumulative effect of changes in accounting principles*.

ADDITIONAL/EXPANDED FOOTNOTE DISCLOSURES

Paragraphs 17, 18 and 20 of SSAP 10R identify new and expanded items of disclosure. The total of gross, adjusted gross, admitted and nonadmitted DTAs and DTLs are required to be disclosed and reported by their tax character (ordinary vs. capital). In addition, the results obtained under each step of the SSAP 10R admissibility test (*i.e.,* the results of paragraph 10a through 10e) are required to be disclosed, by tax character, including the RBC level used in paragraph 10d, if elected. Additional disclosure is also required if the company has elected to admit additional DTAs pursuant to new paragraph 10e and whether the current-period election differs from the prior reporting period. Furthermore, SSAP 10R requires new disclosures on an entity's valuation allowance. These should follow the GAAP prescribed disclosure format for valuation allowances and include the valuation allowance balance; the net change during the year in the total valuation allowance; and adjustments to the beginning-of-the-year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related DTA in future years.

CONCLUSION

SSAP 10R was issued with provisions intended to more appropriately and consistently recognize DTAs for eligible companies, currently restrained by the mechanical limitations of SSAP 10, which "better depicts the true economic condition of the insurer in the statutory financial statements."[8] In its evolution, safeguards were built in to SSAP 10R's RBC threshold that must be satisfied for a company to be eligible for the additional admittance. The American Council of Life Insurers' Chief Actuary Paul Graham, stated that "With this improvement, insurers can have greater access to capital and credit, which is essential to serving current and future policyholders. Just as consumers must demonstrate strong financials to qualify for a loan, life insurers must demonstrate strong financials in order to have access to capital and credit from financial markets,"[9]

Although SSAP 10R is effective as of Dec. 31, 2009, it sunsets after Dec. 31, 2010. As a result, this subject will continue to be under review during 2010, as regulators work on a long-term solution. The SAPWG issued a data call in May 2010 (responses were due June 2010) which requested insurance companies provide their 2008 and 2009 year-end deferred tax data. An interim meeting of the SAPWG was held on July 27, 2010 which discussed the results of the data call, discussed DTA's and the SAPWG received a technical education session from the industry, the American Institute of CPAs and the American Academy of Actuaries. The education sessions covered DTA's and reversals, Accounting and Audits of Deferred Taxes and Deferred Taxes in RBC formulas. There was a low response to the data call and the responses contained numerous errors. The information obtained from this data call and points discussed in the meeting will be utilized by the SAPWG to help determine the appropriate statutory accounting admission guidance for deferred tax assets. The SAPWG plans to expose a recommendation based on its findings and have it voted on in August. If the recommendation is passed it will be subject to a vote in October by the Financial Condition (E) Committee and the Executive Committee as well as the Plenary. While SSAP 10R is a step in the right direction, it is hoped that during 2010 the ongoing review by the SAPWG will give rise to a practical solution for determining the level of admitted DTAs that even more accurately reflects their value.

Authors' Note — *Following the submission of this article, at the NAIC National Summer Meeting, the SAPWG met on August 14, 2010. At this meeting, the SAPWG DTA subgroup exposed a one-year extension of the Dec. 31, 2010 sunset provision in SSAP 10R and additional disclosures on tax planning strategies for a two week comment period ending Aug. 27, 2010.*

END NOTES

1. SSAP 10 Q&A 4.10 does contain an implicit valuation allowance whereby gross DTAs will be reduced if it is more likely than not that the future benefit will not be realized. The SSAP 10 Q&A is not included in SSAP 10R. SSAP 10 continues to provide this Q&A, however, the Q&A does not incorporate the SSAP 10R revisions.
2. Prior to 2001 only current income tax was accounted for under statutory accounting rules.
3. Formerly known as Statement of Financial Accounting Standards No. 109 ("FAS 109"). For purposes of this article, ASC 740 will be referred to as FAS 109.
4. Statement of Statutory Accounting Principles No. 4, "*Assets and Nonadmitted Assets,*" paragraph 3.
5. Statutory Issue Paper No. 83, "*Accounting for Income Taxes,*" paragraph 25.d.
6. The statutory valuation allowance is used strictly to calculate the "adjusted gross deferred tax asset" and is not reflected as a separate reserve within the statutory financial statements.
7. Companies such as title and mortgage insurance and financial guaranty companies, who are not subject to RBC rules, cannot utilize the expanded admittance rules under 10e.
8. NAIC News release, "*NAIC Adopts Accounting Change,*" Dec. 7, 2009.
9. BestWire news release, *NAIC Accounting Changes to Save Life Insurers $11 Billion,"* Dec. 8, 2009.

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CODIFYING THE ECONOMIC SUBSTANCE DOCTRINE: CLARITY, QUESTIONS AND IMPLICATIONS FOR LIFE INSURANCE PRODUCTS

By John T. Adney, Bryan W. Keene and Joel W. Mann

After years of proposals to "codify" the common law economic substance doctrine, the essence of the doctrine was incorporated into the Internal Revenue Code (the "Code") near the end of last March, when President Obama signed the Health Care and Education Reconciliation Act of 2010 into law (the "Act").[1] The Act added to the Code new section 7701(o),[2] entitled "Clarification of Economic Substance Doctrine," in an effort by Congress to address what arguably has been an inconsistent application of the economic substance doctrine by the courts. This codification, which also imposes related tax penalties, was meant in part to combat tax shelter schemes and in part to help offset the revenue costs of health care reform. While new section 7701(o) does not do much to change the core principles of the economic substance doctrine, or of the closely-related business purpose test that is now officially a component of the economic substance doctrine (discussed later in this article), it does have potentially serious implications for taxpayers entering into transactions on or after the effective date of the codification and new penalty taxes—March 31, 2010. This article provides a brief background on the economic substance doctrine, with a focus on its prior application to life insurance products, followed by a summary of the codification and new penalties and then by a discussion of some of the codification's implications for life insurance products and otherwise.

I. BACKGROUND

A. Economic Substance Doctrine

For many years the courts have applied the common law economic substance doctrine to deny tax benefits arising from transactions that do not change a taxpayer's economic position in a meaningful way apart from federal income tax considerations.[3] The origins of the doctrine can be traced back to at least 1935, when the Supreme Court decided *Gregory v. Helvering*.[4] *Gregory* did not explicitly lay out the economic substance doctrine, but it has since been cited routinely as authority for the doctrine.[5] If a court determines that a transaction does not result in sufficient non-tax economic benefits, then any tax benefits, such as deductions, that the taxpayer seeks to claim in connection with the transaction will be denied. As the Tax Court has observed:

> The tax law … requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[6]

The courts have used this test as an objective measure of the relevant facts and circumstances of a transaction to determine whether sufficient non-tax economic benefits exist.[7]

One such non-tax economic benefit that courts have considered in determining whether a transaction possesses economic substance is the potential for profit or economic gain from such a transaction.[8] Clearly, transactions that have been found to lack any potential profit outside of tax considerations have been ruled to lack economic substance.[9] It is those transactions that have the potential for some amount of profit, however, that present the more interesting question—how much profit is enough? In *Sheldon v. Commissioner*, the Tax Court provided some guidance to that question by disallowing interest deductions relating to repurchase agreements of Treasury bills entered into by the taxpayer because "the potential for 'gain' … [was] infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions."[10] Thus, according to the Tax Court in *Sheldon*, a transaction's profit potential must be something more than nominal in comparison to the tax benefits claimed in order for the transaction to have economic substance. Other courts, however, have phrased the economic substance doctrine as requiring a "reasonable possibility of profit,"[11] without stating how much profit would be sufficient. Under such an analysis, it is conceivable that a realistic possibility of even a nominal amount of profit would satisfy the requirements of the doctrine. As discussed below, new section 7701(o) addresses this disparity in the courts' application of the economic substance doctrine to some extent, although the necessary quantum of profit is left in an uncertain state.

B. Business Purpose Requirement and Its Lack of Uniform Application

Courts have also invoked a common law principle closely related to the economic substance doctrine to disallow the claimed tax benefits of a transaction—a requirement that the transaction have a "business purpose" other than tax reduction. This business purpose requirement, in contrast to the economic substance doctrine, has been described as a subjective test, in that it considers a taxpayer's motivation for entering into a transaction: if the court determines that the taxpayer did not intend the transaction to serve a useful non-tax purpose, then the tax benefits claimed to arise from the transaction will be disallowed.[12] For example, in *Goldstein v. Commissioner*,[13] the taxpayer sought to reduce the income tax she would have to pay upon winning the Irish Sweepstakes. She did this by borrowing money and purchasing Treasury bills the year she won the sweepstakes. Her plan was to deduct interest expenses under section 163(a) in that year against the sweepstakes income, and to pay tax on interest income when the Treasury bills matured in a later year in which she would be in a lower tax bracket, thus reducing her overall tax bill on the sweepstakes winnings. In disallowing the interest deductions, the Court of Appeals for the Second Circuit stated that section 163(a) "does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences."[14] In other words, a transaction must have a useful business purpose apart from tax considerations for it to be respected under this business purpose requirement.

The requirement of a business purpose has been used somewhat interchangeably with the economic substance doctrine, resulting in a lack of uniform application of the latter by the courts.[15] Some courts have required the transaction to pass both tests in order for it to be respected for federal tax purposes.[16] As the Sixth Circuit Court of Appeals phrased the requirement in *Pasternak v. Commissioner*, "[t]he threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."[17] Other Courts of Appeals have permitted claimed tax benefits if the transactions giving rise to them exhibited either a subjective business purpose *or* objective economic substance.[18] Still other Courts of Appeals have viewed the inquiry as not involving a "rigid two-step analysis," instead describing the two doctrines as "simply more precise factors to consider" in determining whether to respect a transaction.[19] This lack of uniformity among the appellate courts in applying the "objective" economic substance doctrine and the "subjective" business purpose requirement was a primary target of the clarifications intended by new section 7701(o).

C. Economic Substance as Applied to Life Insurance

The courts have applied the economic substance doctrine in one form or another to life insurance products for many decades. In *Knetsch v. United States*,[20] the Supreme Court found a transaction involving annuity savings bonds to be a "sham" that lacked economic substance. In that case, the taxpayer purchased annuity bonds bearing interest at 2.5 percent and financed the transaction by borrowing money and prepaying interest at 3.5 percent.[21] Because the taxpayer could realize no profits aside from the anticipated tax benefits of claiming deductions for the prepaid interest, the Supreme Court disallowed the interest deductions. Quoting the trial court's opinion, the Court stated that "there was no commercial economic substance … to the transaction."[22] The Court also noted that the net cash value of the annuity bonds would not exceed the amounts the taxpayer paid as interest until 10 years had passed, and even at the end of the annuity bonds' term of 30 years they would be worth only $1,000, which the court characterized as a "relative pittance."[23] Interestingly, this was the first instance in which the Supreme Court used the term "economic substance" in a tax case involving life insurance products.

The United States Court of Claims dealt with the application of the economic substance doctrine to transactions involving non-business life insurance contracts in *Coors v. United States*.[24] In that case, the Internal Revenue Service (the "Service") challenged a wife's claimed deductions for interest on loans used to pay premiums for life insurance contracts that she owned on the life of her husband. The contracts were purchased prior to the effective date of amendments made to section 264 that limited the deductibility of interest on loans (including policy loans) used to purchase or carry life insurance.[25] In determining whether the loans had economic substance, the court noted that the taxpayer's subjective intent in purchasing the contracts and borrowing against them was to provide insurance coverage on the life of the family provider,[26] and that there was no evidence that tax considerations had affected the taxpayer's decisions in any way. Further, substantial death benefits remained under the contracts even after the outstanding loans were subtracted.[27] With these

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considerations in mind, the court held that the contracts insuring the husband's life provided substantial and economically significant protection to the wife and children.[28] This economic protection distinguished the case from *Knetsch*, as did the facts that the interest was not prepaid and the loans were straightforward, ordinary, and not specifically tailored to the policyholder.[29] In contrast, when interest was prepaid on a loan that was specifically tailored to a policyholder, the Court of Appeals for the Tenth Circuit has denied deductions for interest on loans against life insurance contracts.[30]

The Service has also asserted the economic substance doctrine to challenge interest deductions in the context of business-owned life insurance. In *Campbell v. Cen-Tex*,[31] a construction company purchased life insurance contracts covering its key employees in order to meet obligations under its deferred compensation plan and its stock option and redemption plan, and it borrowed against those contracts. The business prepaid four annual premiums for the contracts, and it then effected loans secured by the contracts. The Court of Appeals for the Fifth Circuit held the borrowing transactions to have economic substance,[32] distinguishing the case from *Knetsch* by noting that the death benefits and cash values of the contracts in question would be significant at the end of 20 years, even if maximum loans were taken against the contracts each year.[33] As the court observed, "in addition to net benefit accruals, the policies would have, at the end of twenty years, with maximum loans effected, cash surrender values in excess of $200,000. These potential death benefits and cash surrender values cannot be brought within the *Knetsch* characterization of a 'relative pittance.'"[34] The court further distinguished the transaction from that in *Knetsch* with the observation that the life insurance in *Cen-Tex* fulfilled a "bona fide business purpose and an economic objective" in assisting the business in meeting obligations under its employee benefit plans.[35]

In more recent years, the courts have applied the economic substance doctrine to deny interest deductions and other tax benefits associated with broad-based, leveraged corporate-owned life insurance ("COLI") arrangements,[36] which came under criticism in the early 2000s as "janitor insurance."[37] In a typical arrangement, businesses would enter into contracts insuring the lives of large numbers of their employees, pay premiums designed to enhance the contracts' cash values rapidly, borrow heavily against the contracts' cash values (sometimes at inflated interest rates), and deduct the interest with respect to that indebtedness to offset other taxable income. Although section 264 sets forth specific rules governing the deductibility of interest on indebtedness incurred in connection with life insurance contracts, the Service repeatedly challenged the deductibility of such COLI-related interest.[38]

The main argument that the Service advanced in these cases was violation of the economic substance doctrine and business purpose requirement. For example, in *Dow Chemical Corp. v. United States* (the most recent of the leveraged COLI cases), the Court of Appeals for the Sixth Circuit denied the interest deductions associated with Dow's COLI contracts by invoking the economic substance doctrine.[39] There, the court stated that the contracts did not exhibit any of the non-tax benefits that courts had previously determined relevant to the economic substance of a permanent life insurance contract—positive cash flows, "inside build-up," and the potential for mortality gains.[40] Interestingly, the court in *Dow Chemical* required, as a condition for upholding the claimed interest deductions, that the COLI arrangement exhibit both economic substance and a business purpose, and it noted that because the COLI policies lacked economic substance, it was "unnecessary to discuss Dow's subjective motivation."[41] This illustrates a willingness by the Service and the courts to look to the underlying economics of COLI arrangements as well as the intent of the business in purchasing them in affirming or denying the desired federal income tax treatment.

II. CODIFICATION

As noted previously, the Act added new section 7701(o) to the Code, along with new tax penalties that the Service may impose with respect to transactions that lack economic substance. A discussion of both, in turn, follows.

A. New Section 7701(o)

Under new Code section 7701(o), a transaction (including a series of transactions) will exhibit economic substance and thus retain its federal income tax benefits only if it meets both prongs of the following two-prong test:

1) The transaction must change in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and

2) The taxpayer must have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

In other words, a transaction will retain its intended tax benefits only if it passes an objective analysis of the economic effects on the taxpayer as well as a subjective analysis of the taxpayer's motives for entering into the transaction. Thus, the codification effectively combines the economic substance doctrine and the business purpose requirement under the rubric of a single statutory "economic substance" rule.[42] It is important to note, however, that this new economic substance rule does not apply to individuals, except in cases where transactions are entered into in connection with a trade or business or where an activity is engaged in by the individual for the production of income.[43] This contrasts with the doctrine's usage by some courts—such as in the *Coors* case (discussed above)—that previously have applied the economic substance doctrine to the personal transactions of individuals, although the new statute does not purport to alter the application of the common law doctrine in instances beyond the statute's scope.

The two-prong test of section 7701(o) need only be passed "in the case of any transaction to which the economic substance doctrine is relevant."[44] Therefore, the new rule is not intended to alter the flexibility of the courts' current standards in determining when to utilize an economic substance analysis.[45] In that regard, according to the legislative history of the Act (the "Joint Committee Explanation"), "[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed."[46]

Further, the Joint Committee Explanation states that new section 7701(o) is not intended to disrupt the tax treatment of certain basic transactions that are not currently subject to the economic substance doctrine. These transactions include:

1) the choice between capitalizing a business enterprise with debt or equity;

2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

4) the choice to utilize a related-party entity transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[47]

The Joint Committee Explanation goes on to note that the determination of whether any transaction meets the requirements for specific treatment under any of these provisions remains a question of facts and circumstances.[48]

New section 7701(o) provides special rules for taxpayers choosing to rely on profit potential to satisfy the economic substance test. Section 7701(o)(2)(A) states that profit potential will be taken into account for this purpose only if "the present value of the reasonably expected pre-tax profit from the transaction is *substantial* in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." (Emphasis added.) Under this rule, such a reasonably expected, substantial pre-tax profit can be used to satisfy both the objective, first prong of the statute's test as well as the subjective, second prong. However, fees and other transaction expenses must be subtracted from pre-tax profit before determining whether the profit is substantial.[49] (What constitutes a "substantial" pre-tax profit is discussed later.)

The Act also speaks to whether and how taxpayers can point to taxes other than federal income taxes in attempting to satisfy the new statutory economic substance test. For example, the statute directs the Treasury Department to publish regulations "requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases."[50] Thus, "in appropriate cases," foreign tax *liability* generated by a transaction that is subject to the economic substance test will be subtracted from the transaction's "pre-tax" profit in determining whether that profit is "substantial" enough to satisfy the test. On the other hand, it appears that foreign tax *savings* generated by a transaction can augment the transaction's pre-tax profit potential for purposes of the new rules. For example, the Service has previously concluded that, in the context of corporate distributions, a valid business purpose may exist for U.S. tax purposes when a corporate distribution substantially reduces the amount of tax withholding required by a foreign country.[51] The Act does not appear to disrupt this view, as it merely directs the Treasury

However, fees and other transaction expenses must be subtracted from pre-tax profit before determining whether the profit is substantial.

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Department to promulgate regulations addressing the effect of foreign taxes that present a drag on the transaction's true economics; the directive does not extend to foreign tax savings that actually enhance those economics. Thus, it would seem that the treatment of potential foreign tax savings will continue to be governed by prior law.[52]

In addition to foreign taxes, the Act provides guidance on how state or local income taxes will be reflected in the new statutory economic substance test. In particular, it says that for purposes of both prongs of the test, "any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect."[53] As indicated previously, the two prongs of the test require a meaningful change in the taxpayer's economic position and a substantial purpose for entering the transaction, both determined "apart from Federal income tax effects." Likewise, by virtue of the provision just quoted, the two prongs will be applied "apart from state and local tax effects" if those effects are "related" to a federal income tax effect. This treatment of state and local taxes appears to conflict with a view the Tax Court has previously expressed, in which it indicated that the reduction of state taxes can constitute a valid business purpose.[54] Thus, the inclusion of the state and local taxes rule in the new statute suggests that Congress may have a dim view of transactions that have little economic substance other than a reduction in such taxes. This is an interesting contrast to the treatment of foreign tax savings under the new rules, which, as indicated above, appear to still be available as evidence of economic substance and a business purpose. In any event, the treatment of transactions that rely on state or local tax effects for their validity, which may hinge on what it means for such effects to be "related" to a federal income tax effect, is currently unclear and likely will be made on a case-by-case basis.

In addition to clarifying how taxes other than federal income taxes are reflected in the new economic substance analysis, the Act also creates a special rule for financial accounting benefits. The realization of such benefits has occasionally been argued to constitute a valid non-tax business purpose that may save a transaction from failing the business purpose requirement.[55] New section 7701(o)(4) states that for purposes of satisfying the subjective, second prong of the test, "achieving a financial benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax." In other words, for example, a corporate taxpayer could not argue an improved position on its books of account as a substantial business purpose if such position were created by the tax benefits it was seeking to claim. As the Joint Committee Explanation notes, "[c]laiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (*i.e.,* reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement."[56] Such a claim was made in *Winn-Dixie Stores, Inc. v. Commissioner*, where a projected pre-tax book value of certain leveraged COLI contracts showed a loss while the after-tax value of those contracts showed a profit.[57] The Tax Court held that COLI contracts in question were entered into without any business purpose other than tax savings, and the Court of Appeals for the Eleventh Circuit affirmed this holding.[58]

B. Penalties

Prior to the Act, in a case where the common law economic substance doctrine was invoked to disallow claimed tax benefits, a penalty relating to the understatement of income potentially applied.[59] While that penalty remains intact, the Act creates a new, additional penalty that the Service may assess for the underpayment of federal income tax attributable to tax benefits that are disallowed because the transaction purportedly giving rise to them lacks economic substance or fails to meet the requirements of "any similar rule of law."[60] The new penalty amounts to 20 percent of the underpayment relating to such a transaction, and the penalty rate is increased to 40 percent if the taxpayer did not adequately disclose the relevant facts affecting the tax treatment of the transaction on its tax return.[61]

Unlike many other penalties for underpayment of federal income tax, the penalty added by the Act is a strict liability penalty.[62] In other words, no "reasonable cause" or other exceptions apply on which a taxpayer might rely to avoid the penalty. In many cases, such "reasonable cause" exists, and provides an exception to the imposition of an underpayment penalty, where a taxpayer reasonably relies on an opinion of counsel that concludes there is a greater than 50 percent chance the tax treatment of a transaction will be sustained if challenged by the Service.[63] In the case of an underpayment of tax due to a lack of economic substance, however, the taxpayer simply cannot avoid the penalty, whether through an opinion of counsel or otherwise.[64]

III. IMPLICATIONS

A. Remaining Questions

Although section 7701(o) clarifies that its objective and subjective tests both must be met in order for a transaction

to have economic substance, several aspects of the new enactment remain unclear. Perhaps the logical first question is "when does the economic substance doctrine apply?" Section 7701(o) and the Joint Committee Explanation make clear that the new economic substance test is only to apply when the doctrine is "relevant," and the determination of whether the doctrine should be applied is to be made as if the new section had not been enacted.[65] As the Joint Committee Explanation states, section 7701(o) "does not change present law standards in determining when to utilize an economic substance analysis."[66] Although at first blush it would seem that this statement means that nothing has changed, there are particular practical issues that warrant consideration.

In a teleconference regarding the economic substance doctrine led by Jasper L. Cummings, Yoram Keinan and Mark J. Silverman, the presenters made the argument that the economic substance of a transaction might always come into question, and the doctrine could be applied any time the two-prong test is failed.[67] They gave an example of a Revenue Agent who concludes that a transaction "(a) resulted in favorable tax reporting; (b) did not have business purpose; [and] (c) was not expected to make much money."[68] The argument is that an agent will be inclined to skip the relevance step, and once the agent reaches the foregoing conclusions, the analysis will be complete. A similar argument made during the teleconference is that a Revenue Agent will likely not conclude that the economic substance doctrine applies unless and until the agent perceives a tax-motivated transaction as according to the facts of the transaction, by which point the agent may already have decided to assert a deficiency.[69] These outcomes may be realized now that the Service is armed with a new Code section specifically imposing what was once solely a common law doctrine to be determined by the courts.

Setting aside the potential difficulties in determining when the economic substance doctrine applies, the language of section 7701(o) itself opens up questions as to exactly how it applies and how one goes about satisfying the new rules. As noted above, in order to pass the two-prong test a taxpayer must establish that a transaction 1) will have "meaningful" non-tax economic effects, and 2) was entered into for a "substantial" non-tax business purpose.[70] To establish this, a taxpayer can rely on factors other than the transaction's profit potential. However, if a taxpayer intends to rely on profit potential to satisfy either prong of the test, the new rules state that "the present value of the reasonably expected pre-tax profit from the transaction [must be] substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected."[71]

Thus, the key to satisfying the two-prong test by reference to profit potential is establishing that such profit is reasonably expected to be "substantial" in relation to the claimed tax benefits. The new rules do not define what standard will be used in assessing whether an anticipated profit is substantial in this context. Instead, the Joint Committee Explanation merely cites a blanket statement for support.[72] The statement, which comes from *Rice's Toyota World v. Commissioner*, is that "the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."[73] Although this statement stands for the proposition that there must be at least some amount of profit potential, it does not help in answering what amount might be considered substantial.

Presumably, the potential profit would need to be more than nominal, as noted in the above discussion of *Sheldon v. Commissioner*,[74] but apart from this, taxpayers will likely remain subject to the Service's and the courts' interpretations of what constitutes a substantial profit relative to the transaction's expected tax benefits. Although not directly applicable, Treasury regulation section 1.170A-9(f)(2), relating to the definition of a "publicly supported" organization, provides an example of a circumstance in which the Service has quantified the term "substantial." There, "substantial" is defined as 33-1/3 percent. Could it be that this same standard would apply under the new economic substance rule, in that the present value of the reasonably expected pre-tax profits would be required to be at least 33-1/3 percent of the present value of the expected net tax benefits? Even if that were the case, the question remains as to how the present value of such pre-tax profits should be calculated. Should the method be based on a rate of return associated with the related transaction, or perhaps on a riskless rate of return? It is these types of uncertainties that taxpayers, the courts, and the Service must consider now that section 7701(o) has been added to the Code. Thus, taxpayers would be wise to review and understand any standards that the Service and the courts may have applied in this area to date.

B. Uncertainty Moving Forward

In view of the uncertainty regarding potential questions about

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the language of new section 7701(o), both the Service and the Treasury Department are considering releasing guidance on the codification of the economic substance doctrine. The Office of Chief Counsel of the Service has opened a new guidance project regarding section 7701(o), and the Treasury Department has requested comments.[75] Apart from these developments, it is unclear how the new section will affect the Service's actions in the future. It is possible that new section 7701(o) will provide an additional, more concrete tool to which the Service can refer in questioning certain transactions on audit. As noted above, one practical implication might be that Revenue Agents will be more likely to raise economic substance challenges to transactions. Additionally, the codification of the economic substance doctrine could provide a useful litigation tool for the Service. In fact, the Service's Associate Chief Counsel (Corporate), William D. Alexander, said in public remarks on April 23, 2010, that new section 7701(o) "might actually make it easier" for the Service to prevail in future litigation similar to that in *Shell Petroleum Inc. v. United States*,[76] a district court case involving the carryback of a consolidated net capital loss in which the Service failed to sustain its challenge to the transaction on economic substance grounds.[77] Interestingly, Mr. Alexander also recently noted that the codification of the economic substance doctrine would not change the way in which the Service might rule on a particular issue. The Service, according to Mr. Alexander, "assume[s] that the economic substance doctrine exists and has always existed. [The Service] would issue the same ruling that [it] would have issued before" the enactment of the new statute.[78] While perhaps helpful, the latter statement does not alleviate the uncertainty surrounding how the Service will make use of new section 7701(o) in the future.

If the new penalty applies, the taxpayer implicated in the transaction would find no refuge in relying on an opinion of counsel, since the new penalty tax is one of strict liability.

As indicated previously,[79] in recent years courts have applied the judicial economic substance doctrine and the business purpose test to deny tax benefits associated with broad-based leveraged COLI. As a result of those decisions and changes in the Code relating to the deductibility of policy loan interest, such leveraged arrangements have generally been abandoned following the 1996 change to section 264(a)(4) (although a number of arrangements grandfathered by legislation in 1986 remain in force, for which section 264 continues to allow interest deductions). Conceivably, however, the Service could challenge other types of COLI arrangements that it believes lack economic substance. If the Service were to find particular features of a COLI arrangement to be troublesome, the new statutory economic substance rule could be a convenient avenue for the Service to challenge the arrangement, even absent the aggravating factors involving leverage that were present in the earlier court cases.

In addition to the foregoing implications of new section 7701(o), it is worth considering at least one aspect of the new penalty provisions the Act added to the Code. As noted above, the Act creates a strict liability penalty tax for the underpayment of federal income tax attributable to the disallowance of claimed tax benefits relating to a transaction that lacks economic substance, or to one that fails to meet the requirements of "any similar rule of law."[80] The Joint Committee Explanation provides some assistance in ascertaining what "any similar rule of law" means, stating that "[i]t is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine."[81] This potentially means that if a similar doctrine, *e.g.*, the "sham transaction doctrine" or the "step transaction doctrine," were to apply to disallow the tax benefits of a transaction, the tax penalty provisions added to the Code by the Act could apply to any underpayment of income tax resulting from the disallowance. Conceivably, this concept could be extended to a common law tax rule developed to apply to insurance products, such as the "investor control doctrine," although this remains unclear. If the new penalty applies, the taxpayer implicated in the transaction would find no refuge in relying on an opinion of counsel, since the new penalty tax is one of strict liability.[82]

IV. CONCLUSION

Congress's codification of the economic substance doctrine in new section 7701(o) provides a helpful clarification in that it is now understood that to satisfy the doctrine a transaction must pass both the objective and subjective prongs of a two-prong test. Despite this clarification, however, taxpayers would do well to consider several resulting implications, including uncertainties in the interpretation of the wording

of section 7701(o), the way in which the Service will apply the newly codified doctrine, and whether the new strict liability penalty will be assessed when other tax doctrines are invoked. Further, it is possible that the codification of the economic substance doctrine gives the Service a new tool with which it could more aggressively challenge transactions, including those involving life insurance products. Hopefully, the new guidance project that the Service and the Treasury Department have opened will assist them in dispelling unnecessary confusion in the application of new section 7701(o) and the related penalties. Achieving greater certainty in this area will become even more important as Congress acts to curb ballooning federal deficits by broadening the tax base and increasing marginal rates, prompting taxpayers to examine additional ways to contain their tax burdens.

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END NOTES

1. Pub. L. No. 111-152, § 1409 (2010). Since 2001 there have been several proposals in Congress to codify the economic substance doctrine. *See* S. Amend. 2708 to H.R. 4297, 109th Cong., 2d Sess. (Feb. 2, 2006), section 511, "Clarification of Economic Substance Doctrine"; S. 1054, 108th Cong., 1st Sess. (May 13, 2003), section 301, "Clarification of the Economic Substance Doctrine"; S. 476, 108th Cong., 1st Sess. (Feb. 27, 2003), section 701, "Clarification of Economic Substance Doctrine"; H.R. 5095, 107th Cong., 2d Sess. (July 11, 2002), section 101, "Clarification of Economic Substance Doctrine"; H.R. 2520, 107th Cong., 1st Sess. (July 17, 2001), section 101, "Clarification of Economic Substance Doctrine."
2. All references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
3. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960); Dow Chemical Corp. v. United States, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003), *cert. denied*, 127 U.S. 1251 (2007); Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004), *cert. denied*, 127 S. Ct. 1261 (2007); *In re* C.M. Holdings, Inc., 301 F.3d 96 (3d Cir. 2002), *aff'g* 254 B.R. 578 (D. Del. 2000); ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).
4. 293 U.S. 465 (1935).
5. *See, e.g., Knetsch*, 364 U.S. at 365; *Coltec Industries*, 454 F.3d at 1352.
6. *ACM Partnership*, 73 T.C.M. at 2215.
7. *See, e.g., Coltec Industries*, 454 F.3d at 1356 ("the economic substance of a transaction must be viewed objectively rather than subjectively."); *In re CM Holdings*, 301 F.3d at 103 (stating that the objective formulation of the economic substance doctrine is simple: "absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way.").
8. *See, e.g., Knetsch*, 364 U.S. 361; Rice's Toyota World v. Comm'r, 752 F.2d 89 (4th Cir. 1985); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966); Sheldon v. Comm'r, 94 T.C. 738 (1990).
9. *See, e.g., Knetsch*, 364 U.S. 361; *Goldstein*, 364 F.2d 734.
10. *Sheldon*, 94 T.C. at 768.
11. *Rice's Toyota World*, 752 F.2d at 94; Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781 (5th Cir. 2001).
12. *See, e.g.*, ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966); American Electric Power, Inc. v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004).
13. *Goldstein*, 364 F.2d 734.
14. *Id.* at 740.
15. "The casebooks are already glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." Collins v. Comm'r, 857 F.2d 1383, 1386 (9th Cir. 1988).
16. *See, e.g.*, Klamath Strategic Investment Fund v. United States, 568 F.3d 537 (5th Cir. 2009); Pasternak v. Comm'r, 990 F.2d 893 (6th Cir. 1993).
17. *Pasternak*, 990 F.2d at 898.
18. *See, e.g.*, IES Industries v. United States, 253 F.3d 350 (8th Cir. 2001); Rice's Toyota World v. Comm'r, 752 F.2d 89 (4th Cir. 1985).
19. *See, e.g.*, ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998) (citing Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990)).
20. 364 U.S. 361 (1960).
21. *See id.* at 362-63.
22. *Id.* at 364-66.
23. *See id.* at 366 n.3.
24. 572 F.2d 826 (Ct. Cl. 1978).
25. The court noted that section 264(a)(3) (regarding loans to purchase or carry certain life insurance contracts under a plan that contemplates systematic borrowing of part or all of the contract's cash value) might have had some applicability to the case, but the contracts in question were purchased prior to the Aug. 6, 1963, effective date of section 264(a)(3). Also, the tax years involved in *Coors* preceded the effective date of section 163(h), which generally disallows deductions for "personal interest," and the contracts in *Coors* were issued prior to the addition of section 264(a)(4) to the Code in 1986, which, with certain exceptions, generally disallows deductions for interest on indebtedness with respect to life insurance contracts.
26. *See Coors*, 572 F.2d at 834.
27. *See id.* at 838.
28. *See id.* at 833. The government also argued that the interest paid on the loans was not, in substance, "interest" at all, but rather the payment of premiums for life insurance coverage. Based on this attempted recharacterization of the loans, the government then argued that the "premium" payments were "personal, living, or family expenses" that were nondeductible pursuant to section 262. The court rejected the recharacterization of the loans and concluded that they were, in substance, loans that generated interest expenses.

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END NOTES (CONTINUED FROM PAGE 39)

[29] *See id.* at 835.
[30] *See, e.g.*, Golsen v. Comm'r, 445 F.2d 985 (10th Cir. 1971).
[31] 377 F.2d 688 (5th Cir. 1967).
[32] *See id.* at 693 ("The policies purchased provided for a beneficial interest. The transaction was not without economic value, economic significance, economic substance, or commercial substance.").
[33] *See id.*
[34] *Id.*
[35] *Id.* at 692.
[36] *See* Dow Chemical Corp. v. United States, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003), *cert. denied*, 127 U.S. 1251 (2007); American Electric Power, Inc. v. United States, 326 F.3d 737 (6th Cir. 2003), *aff'g* 136 F. Supp. 2d 762 (S.D. Ohio 2001), *cert. denied*, 540 U.S. 1104 (2004); *In re* C.M. Holdings, Inc., 301 F.3d 96 (3d Cir. 2002), *aff'g* 254 B.R. 578 (D. Del. 2000); Winn-Dixie Stores, Inc. v. Comm'r, 254 F.3d 1313 (11th Cir. 2001), *aff'g* 113 T.C. 254 (1999), *cert. denied*, 535 U.S. 986 (2002).
[37] For a discussion of this controversy *see* Adney, Van Brunt, & Keene, "COLI Reconsidered," 56 *J. Fin. Serv. Prof.*, No. 6, at 41 (2002).
[38] *See id.*
[39] *Dow Chemical*, 435 F.3d at 605.
[40] *See id.*; *see also American Electric Power*, 326 F.3d 737; *In re C.M. Holdings*, 301 F.3d 96; *Winn-Dixie Stores*, 254 F.3d 1313.
[41] *See Dow Chemical*, 435 F.3d at 605.
[42] *See also* section 7701(o)(5)(A) ("The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.").
[43] *See* section 7701(o)(5)(B).
[44] Section 7701(o)(1).
[45] *See* section 7701(o)(5)(C) ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if [section 7701(o)] had never been enacted.").
[46] Staff of J. Comm. on Tax'n, 111th Cong., Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," 152 n.344 (JCX-18-10, March 21, 2010) [hereinafter Joint Committee Explanation]. There are no other committee reports regarding the Act, and thus its sole "legislative history" is the Joint Committee Explanation.
[47] *Id.* at 152-53.
[48] *Id.* at 153.
[49] *See* section 7701(o)(2)(B).
[50] *Id.*
[51] *See* Rev. Rul. 89-101, 1989 C.B. 67. *See also* PLR 8705081 (Nov. 6, 1987); PLR 8511086 (Dec. 20, 1984). Private letter rulings issued by the Service do not constitute legal precedent that can be cited or relied upon, except by the taxpayers to which they are issued. *See* section 6110(k).
[52] Joint Committee Explanation, *supra* note 46, at 155 n.357 ("There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law.").
[53] Section 7701(o)(3).
[54] *See* Virginia Historic Tax Credit Fund 2001 LP v. Comm'r, 98 T.C.M. (CCH) 630 (2009). *But see* Treas. Reg. § 1.355-2(b)(5), Example (7) (for purposes of section 355, reducing state taxes does not constitute a valid business purpose if the reduction of federal income taxes is greater than the reduction of state taxes).
[55] *See, e.g.*, American Electric Power, Inc. v. United States, 326 F.3d 737 (6th Cir. 2003); Wells Fargo & Company v. United States, 105 AFTR 2d 2010-377 (Fed. Cl. Jan. 8, 2010).
[56] Joint Committee Explanation, *supra* note 46, at 154 n.355 (citing American Electric Power, Inc. v. United States, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio)).
[57] 113 T.C. 254, 287 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).
[58] *See id.*
[59] *See* section 6662(a) and (d).
[60] *See* section 6662(b)(6).
[61] *See* section 6662(i).
[62] *See* section 6664(c)(2) and (d)(2).
[63] *See* Treas. Reg. § 1.6662-4(g)(4)(i)(B).
[64] *See* Joint Committee Explanation, *supra* note 46, at 156.
[65] *See* section 7701(o)(5)(C); Joint Committee Explanation, *supra* note 46, at 152.
[66] Joint Committee Explanation, *supra* note 46, at 152.
[67] *See* Jasper L. Cummings, Jr., Yoram Keinan, and Mark J. Silverman, *The Economic Substance Doctrine*, ABA Tax Section Corporate Tax Committee, at 17 (March 31, 2010) *available at* http://www.steptoe.com/assets/attachments/4023.pdf (last visited May 5, 2010).
[68] *Id.*
[69] *See id.* at 19.
[70] *See* section 7701(o)(1).
[71] Section 7701(o)(2)(A).
[72] *See* Joint Committee Explanation, *supra* note 46, at 155 n.356.
[73] 752 F.2d 89, 94 (4th Cir. 1985).
[74] *See supra* Part I.A.
[75] At a Practicing Law Institute conference on May 14, 2010, Robert Crnkovich, senior counsel in the Treasury's Office of Tax Legislative Counsel, requested that taxpayers submit comments and concerns to the Service and the Department of Treasury regarding the government's application of new section 7701(o).
[76] 102 AFTR 2d 2008-5085 (S.D. Tex. 2008).
[77] William J. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service, Address at the Penn State Dickinson School of Law (Apr. 23, 2010).
[78] William J. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service, Address at the Tax Executives Institute's 60th Midyear Conference (Apr. 13, 2010).
[79] *See supra* Part I.C.
[80] *See* section 6662(b)(6).
[81] *See* Joint Committee Explanation, *supra* note 46, at 155 n.359.
[82] *See* section 6664(c)(1) and (d)(1).

THE MYSTERY OF PLR 201006002

By Lori J. Jones and Julie V. Goosman

In PLR 201006002, the Internal Revenue Service (IRS) *appears* to apply section 351 and Rev. Rul. 94-45 to a variety of reinsurance transactions. At first glance, the PLR seems to break new ground by applying section 351 to the transfer of assets and insurance liabilities in an indemnity reinsurance transaction. However, as described below, a more in-depth review leads one to conclude that even though the PLR refers to a section 351 transfer "in the context of an indemnity coinsurance transaction," it is not referring to the transfer of assets underlying a transfer of insurance reserves. We will explain the reasons why the IRS should rule on the application of section 351 to the transfer of assets and reserves in an indemnity coinsurance transaction where the ceding company transfers more assets to the assuming company than it would in an arms-length transaction and, therefore, the ceding company actually receives or is deemed to receive stock in the exchange for the transferred assets including the value of insurance in force. We also will summarize other interesting rulings in the PLR.

BACKGROUND

Rev. Rul. 94-45, 1994-2 C.B. 39, concludes that the transfer of assets and statutory reserves by a life insurance company pursuant to an assumption reinsurance transaction to its wholly-owned subsidiary is a nonrecognition transaction under section 351. In the ruling, the life company transferred assets in excess of the assets that would have been transferred pursuant to an arms-length reinsurance transaction. No gain or loss was recognized on the transfer of the assets in exchange for stock under section 351 and the section 807 insurance reserves were treated as having been transferred in a step-in-the-shoes manner to the assuming company. In addition, the ruling holds that the unamortized section 848 policy acquisition expenses attributable to the transferred business are transferred to the transferee and continue to be amortized in the same manner as they would have been amortized by the transferor. Rev. Rul. 94-45 revoked Rev. Rul. 75-382, 1975-2 C.B. 121, which had concluded that while section 351 applied to avoid recognition of gain or loss on the transfer of all of the assets, the reinsurance was still taxable under subchapter L and Treas. Reg. § 1.817-4(d).

GENERAL CONCLUSIONS IN PLR 201006002

In PLR 201006002 (Nov. 6, 2009), there were numerous transactions occurring at or around the same time, including assumption reinsurance, indemnity coinsurance, co/modco reinsurance, the transfer of noninsurance liabilities and matching assets, and the transfer of obligations through a novation of existing reinsurance agreements. The focus of this article is on the indemnity coinsurance arrangements. The PLR first describes the assumption reinsurance transaction as a transfer of policies pursuant to an assumption reinsurance transaction where LifeCo5 assumes the statutory reserve liabilities of LifeCo3 and certain other related liabilities. A similar description applies to the transfer between LifeCo1 and LifeCo2. In contrast, the PLR describes the coinsurance portion of the transaction as follows:

> Also, in the context of an indemnity coinsurance transaction, LifeCo3 will transfer assets to LifeCo5 in excess of the premium that LifeCo3 would have paid in an arms-length transaction (net of any ceding commission that LifeCo3 would have received in such transaction) (the "Z Assets") and LifeCo5 will assume from LifeCo 3 miscellaneous liabilities which are not part of that transaction (the "Miscellaneous Liabilities").

The description of the coinsurance arrangement in the context of the LifeCo1/LifeCo2 proposed transactions is similar.

The PLR concludes in rulings (1) and (8) that section 351 applies to the Z assets and the VA Assets and X Receivables in the LifeCo1/LifeCo2 transactions. The $64,000 question is whether the section 351 transaction includes all of the assets transferred by the respective transferor in each indemnity coinsurance transaction. Apparently the answer is that when the PLR states that it applies section 351 to assets transferred "in the context of an indemnity coinsurance transaction" it means those "excess" (*i.e.,* surplus) assets over and above the assets transferred as premiums for reinsurance. Therefore, the PLR suggests that the IRS allowed the integrated transaction to be bifurcated into two pieces, one piece that was taxable under

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the reinsurance rules in Treas. Reg. § 1.817-4(d) (although no rulings specifically addressed the taxable part) and another piece involving the transfer of the surplus and noninsurance liabilities that was tax free under section 351 and presumably in exchange for stock of the transferee. This is arguably inconsistent with case law which concludes that section 351 is mandatory and bifurcation of an integrated transaction is not permitted.[1]

Besides the somewhat confusing description of the assets covered by section 351 (but clear lack of reference to statutory reserves), there are other indications in the ruling which suggest that section 351 was not applied to the transfer of the insurance reserves and related assets with respect to the indemnity coinsurance transaction. For example, representation (I) states that the tax bases of the transferred assets exceed liabilities for section 357(c) purposes. In determining the basis of the transferred assets, the taxpayer represented that only the unamortized section 848 expenses related to the assumption reinsurance transaction were taken into account.[2] If section 351 had applied to the business transferred by indemnity reinsurance, the unamortized section 848 expenses allocable to that business also should have been included. *See also* rep (DD). Ruling (4) applies the same rule to determine the basis of the "new" stock in the hands of the transferor. Also, as discussed below, rulings (14) and (15) suggest section 351 did not apply to assets transferred equal to the statutory reserves in the indemnity reinsurance transaction.

There is no good policy reason why section 351 should not apply to the entire indemnity coinsurance transaction. Even under the more restrictive conclusion in Rev. Rul. 75-382, section 351 applied to the transfer of all the assets. Furthermore, Rev. Rul. 94-45 supports the position that no gain should by recognized by the ceding company when the ceding commission is being paid in stock of the assuming company as part of a section 351 transaction. Because of the restrictive regulatory nature of assumption reinsurance transactions (*e.g.,* policyholder consents), many companies have used indemnity reinsurance in recent years to effect a complete transfer of a book of business. Obviously there is a wide variation in the manner in which indemnity reinsurance can be used—some arrangements having less qualities of permanence than others. The IRS should extend the application of section 351 to indemnity reinsurance transactions which involve the transfer of surplus to an assuming company or at least where the indemnity reinsurance transaction is of a permanent or semi-permanent nature.

The IRS has acknowledged this distinction with the issuance of Treas. Reg. § 1.197-2(g)(5)(iii)(A)(2). In most section 197 transactions, any section 197 intangibles created in the transaction are unable to be written off by the taxpayer until all section 197 intangibles acquired in the transaction are disposed of. The regulations make an exception to this general rule for a subsequent cession of insurance risks acquired in an assumption reinsurance transaction (or a section 338(h)(10) election deemed to be an assumption reinsurance transaction) that created a section 197 intangible. Because of the wide variation in the permanence of indemnity reinsurance transactions, to qualify for this exception, Treas. Reg. § 1.197-2(g)(5)(iii)(A)(2) requires that sufficient economic rights be transferred and the indemnity reinsurance transaction not contain a right to recover a significant portion of the future profits on the reinsured contracts through an experience refund or recapture provision. At the least, the IRS should extend this analysis involving indemnity reinsurance to potentially treat reinsurance transactions meeting the section 197 requirements as section 351 transfers.

OTHER ITEMS OF INTEREST IN PLR

Other items of interest include representations and rulings on derivatives, market discount bonds and the application of the disproportionate asset acquisition rule in the life/nonlife consolidated return regulations, Treas. Reg. § 1.1502-47. In representations (H) and (CC), the taxpayer stated that for purposes of determining that the fair market value of transferred assets exceeds transferred liabilities, an "in the money" derivative is treated as an asset to the extent it is in the money and an "out of the money" derivative is treated as a liability to the extent it is out of the money. The representations also state that a derivative that is "at the money" is treated as neither an asset nor a liability. Representations (I) and (DD) contain similar statements that a derivative for which the present value of the payments that are anticipated to be received from the counterparty to the derivative contract is less than the present value of the payments that are anticipated to be made to the counterparty of the derivative contract is treated as a liability described in section 357(c)(3)(A). Section 357(c)(3)(A) provides that a liability is not included for purposes of section 357(c) if the liability the payment of which either would give rise to a deduction or would be described in section 736(a). Presumably, in this case, the net payments to the counter-

party under the derivative would give rise to a deduction to the transferee under Treas. Reg. § 1.446-3 or a similar provision. There is some guidance which suggests that a swap derivative is property (presumably meaning an asset rather than a liability) whether it is in or out of the money.[3] However, in Rev. Rul. 95-45, 1995-1 C.B. 53, the IRS concluded that the transfer of a corporation's obligation to provide replacement securities to a broker-dealer pursuant to a short sale was the assumption of a liability for purposes of sections 357 and 358 to the extent the transferor had a basis in the short-sale liability. In any event, the PLR appears to adopt an economic approach to the treatment of derivatives and whether they are assets or liabilities transferred in connection with section 351.[4]

Another set of rulings deals with the transfer of market discount bonds. Rulings (2) and (9) provide that no gain or loss will be recognized by the transferor, except that any gain on the transfer of a market discount bond, to the extent the gain does not exceed the accrued market discount on that bond as of the date of the exchange, will be recognized as ordinary income. The basis for this conclusion is section 1276(a) which provides for the recognition of gain on the disposition of any market discount bond notwithstanding other provisions of subtitle A, which gain is then treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. It appears that this is the first time the IRS has included such a ruling in the context of a section 351 transaction.

The last interesting rulings, (14) and (15), deal with the application of Treas. Reg. § 1.1502-47(d) and the disproportionate asset acquisition rules. Treas. Reg. § 1.1502-47(d) provides certain requirements which must be satisfied so that a newly-formed or newly-acquired life insurance company can be eligible to join in a life/nonlife consolidated return. Treas. Reg. § 1.1502-47(d)(12)(vii) provides that a corporation must not undergo during the base period a disproportionate asset acquisition attributable to an acquisition of assets from outside the group in transactions not conducted in the ordinary course of its trade or business (special acquisitions). Among the factors and rules used to determine whether such an acquisition has occurred is the portion of premiums generated during the last taxable year of the base period which are attributable to special acquisitions. For purposes of applying Treas. Reg. § 1.1502-47(d)(12)(viii)(C), ruling (15) concludes that the assets transferred in the indemnity coinsurance transactions are not premiums received from special acquisitions. This favorable ruling applies only to the assets transferred in the indemnity reinsurance transactions since, presumably, as a result of the application of section 351 and Rev. Rul. 94-45 to the assumption reinsurance transactions, the subchapter L reinsurance rules were overridden and therefore there was no premium transferred and no need for a favorable ruling on the assumption transaction.

CONCLUSION

We hope that we have made a persuasive case for analyzing the underlying economics of the transaction to determine impact and classification rather than arbitrarily determining results based upon reinsurance transaction categories. The industry has evolved in its use of indemnity reinsurance—hopefully we will see the IRS develop the rules around section 351 transactions involving the transfer of insurance assets that address the ways indemnity transactions are used today in the industry. ◀

END NOTES

1. *See, eg., Borggaard, Howard K.,* T.C. Memo. 1979-458 (1979), Rev. Rul. 73-16, 1973-1 C.B. 186.
2. Rev. Rul. 94-45, holding (3), concludes that the basis of the assets for section 357(c) purposes includes the transferred unamortized deferred acquisition cost.
3. For example, in FSA 1999-733 (Aug. 6, 1993), the IRS stated that, "It is the *Service's* position that an interest rate swap constitutes property in the ordinary sense. A swap can flip from an obligation to make a payment to a right to receive a payment, and back again. Cf., *e.g., Stavisky v. Commissioner,* 34 T.C. 140, 142 (1960). An interest rate swap constitutes a bundle of rights and obligations…"
4. In addition, Ruling (4) provides that the basis in the LifeCo5 stock is not reduced by liabilities described in section 357(c)(3). Therefore, it appears that the IRS did not apply section 358(h). That section generally requires a basis reduction in the stock received by a transferor (but not below fair market value) for the transfer of any liability which is defined in section 358(h)(3) as any "fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title." There are several exceptions in section 358(h)(2) whereby the basis reduction rule will not apply to the transfer of a liability. Section 358(h) was enacted in 2000 in response to the "Son of Boss" transactions.

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ACTUARIES INVOLVEMENT IN TAX

By Ame R.T. Biggart

The Taxation Section of the Society of Actuaries recently conducted a survey of its members to get a better understanding of how actuaries are being utilized in areas where tax plays a role within the insurance industry. Members were asked about their personal involvement with tax in various capacities. In addition, the survey inquired about the use of other internal actuaries and the reliance on outside assistance for the various tax functions. Thank you to all 115 members who took the time to provide responses to this survey.

It should come as no surprise that the majority of the respondents were actuaries working for insurance companies (over 80 percent), and of the respondents that were not actuaries, the majority (80 percent) were either accountants or lawyers, consistent with the Taxation Section membership.

There was a fairly even distribution of responses across company size, and only 20 percent of insurance company responses said they have a formal "Tax Actuary" position. The prevalence of a "Tax Actuary" role within the insurance industry is size sensitive as 80 percent of the respondents that had this position were companies with over $100 billion in assets. These results are little changed from our *"Role of the Tax Actuary"* survey conducted five years ago by Kory Olsen & Steven Chamberlin (September 2005 *Taxing Times*).

The current survey also inquired about the existence and background of a formal "Tax Director" role. The results showed that 61 percent of insurance companies have a Tax Director, but only one response claimed the individual was an actuary. Over 75 percent of firms surveyed fill this position with an accountant and most of the remaining firms filled this position with a lawyer.

As expected, actuaries are utilized quite extensively within the traditional area of product design and pricing. It was interesting to see that up to 80 percent of respondents also utilize some level of outside actuarial support for this function (*see* Table 1). Looking deeper into this result—large companies are less likely to seek this outside help than smaller firms.

TABLE 1

	Product Design	*Product Pricing*
Personally Responsible/Consulted	59%	57%
Internal Actuaries Responsible/Consulted	87%	90%
Outside Actuarial Support	75%	80%
Outside Actuarial Support (Over 100B)	18%	18%

Actuaries are also deeply involved in tax reserve methods and assumptions, tax reserve to Statutory reserve ratio/trend review, and the documentation of tax reserves for audit purposes (*see* Table 2). When actuaries did not fill these roles, they were consulted for tax reserve issues on average 25 percent of the time; however it was less likely that outside actuarial support would be sought with regard to tax reserves.

TABLE 2

Tax Reserves:	*Documentation for Audit*	*Ratio/Trend Review vs. STAT*	*Methodology & Assumptions*
Personally Responsible/Consulted	54%	56%	67%
Internal Actuaries Responsible/ Consulted	90%	83%	84%
Outside Actuarial Support	13%	25%	21%

Product tax was another area where actuaries had strong involvement—responsible or consulted between 43-76 percent of the time. This area includes guidance on IRC Sec. 7702/7702A for life insurance, guidance on IRC Sec. 72, 1031, & 1035 for annuities, policy administration of IRC Sec. 7702/7702A, and correction programs involving 7702, 7702A, 817(h), etc. (*see* Table 3 on page 46)

The survey also asked if actuaries are responsible or consulted in writing opinion letters, providing tax litigation support,

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TABLE 3				
Product Tax:	*Guidance on 7702/7702A*	*Policy Admin. of 7702/7702A*	*Corrections of 7702, 7702A, 817(h)*	*Guidance on 72, 1031, & 1035*
Personally Responsible/Consulted	61%	56%	49%	43%
Internal Actuaries Responsible/Consulted	74%	76%	66%	63%
Outside Actuarial Support	31%	14%	0%	0%
Outside Legal Support	38%	43%	70%	64%

and providing IRS audit support. The results showed that actuaries were involved to an increasing degree for these three areas with the most involvement in audit support. Survey participants were also asked if actuaries were involved in the assessment of the tax impact of regulatory guidance and in projecting planning initiatives for pending new guidance. Respondents were either responsible or consulted up to 84 percent of the time (*see* Table 4).

Outside actuarial support was not used often for the subject areas in Tables 3 and 4, however the percentage of companies utilizing outside legal assistance is high (up to 72 percent). This could mask actuarial involvement, as many law firms often engage outside actuarial assistance when needed on behalf of their clients as opposed to insurance companies hiring them directly.

Several questions focused on financial reporting functions. Actuaries responded that they were much more likely to be consulted with regard to these tasks, as opposed to being responsible for them. Financial reporting functions were unlikely to be handled by outside actuarial support. The write in responses for "Other Support" provided evidence that Internal Accountants were predominantly responsible for these functions (*see* Table 5 on next page).

TABLE 4				
Legal/Regulatory:	*Personally Responsible/ Consulted*	*Internal Actuaries Responsible/ Consulted*	*Outside Actuarial Support*	*Outside Legal Support*
Opinion letters (including formal cites)	37%	47%	8%	58%
Tax Litigation support	37%	65%	11%	72%
IRS Audit support on actuarial issues	60%	86%	15%	46%
Assessment of the tax impact of regulatory guidance (new or proposed)	70%	83%	12%	24%
Project planning initiatives for pending new guidance and determining approach to take	57%	84%	31%	31%

TABLE 5				
Financial Reporting:	***Personally Responsible/ Consulted***	***Internal Actuaries Responsible/ Consulted***	***Outside Actuarial Support***	***Other Support***
Reporting & Withholding	15%	18%	0%	73%
Life/Non-Life consolidation	10%	20%	0%	83%
Tax Return Review	17%	24%	0%	58%
Premium and other State Taxes	7%	26%	0%	89%
Dividends Received Deduction	21%	42%	10%	50%
Tax Return Preparation	35%	43%	7%	53%
Valuation allowances	15%	47%	14%	71%
Calculation of GAAP DTA/DTL	20%	53%	0%	75%
Calculation of STAT DTA/DTL	30%	56%	0%	70%

TABLE 6				
	Personally Responsible/ Consulted	***Internal Actuaries Responsible/ Consulted***	***Outside Actuarial Support***	***Other Support***
Advanced Underwriting	13%	52%	0%	80%
Corporate Structure	19%	42%	0%	50%
Investment Management	24%	69%	0%	75%
Tax Planning	40%	66%	7%	50%
Mergers & Acquisitions	39%	72%	31%	23%
Capital Management	41%	87%	25%	63%
Reinsurance transactions	65%	83%	20%	80%

The tax functions highlighted in Table 6 also showed a high incidence of "Other Support" responses and further review showed that these roles were often provided by nonactuarial internal resources. Although these tax functions all had high percentages of other support responses, they also had a respectable level of involvement from the actuarial profession (*see* Table 6 above).

Pension and health tax issues were also areas covered by the survey. These areas showed moderate involvement by actuaries (16-34 percent) and outside actuarial support (11-20 percent), but were much more likely to use internal accountants.

Actuaries surveyed had limited involvement in Property & Casualty tax issues. With the majority of actuaries responding to the survey being from life and annuity, health, and pension companies, these results are not surprising.

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CONCLUSIONS

The survey provides a wealth of information that can be looked at from many perspectives. The results show a fair amount of involvement from the actuarial community in tax matters. Areas with strong actuarial involvement not surprisingly include product pricing, product design, product tax, tax reserves and legal/regulatory areas.

The survey highlights plenty of areas where the Taxation Section can look to better serve its membership, and as the section council continues to review the survey results, additional opportunities to educate membership will no doubt be highlighted.

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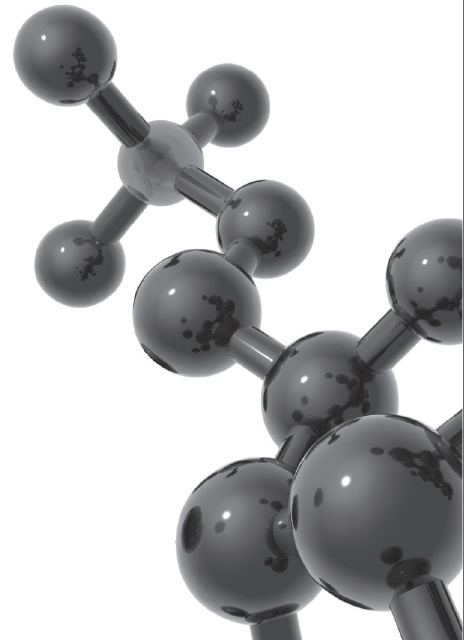

ACLI UPDATE
LEGISLATIVE AND REGULATORY DEVELOPMENTS

By Walter Welsh and Mandana Parsazad

There have been several developments affecting taxation of life insurance companies and products since our last report in the May 2010 edition. ACLI and its many members have been engaged with regulators and legislators as they have considered new guidance and legislation.

GUIDANCE ON ACTUARIAL GUIDELINE 43 - NOTICE 2010-29

Notice 2010-29, issued by the Treasury Department (Treasury) and the Internal Revenue Service (IRS), was a welcome step in their ongoing effort to provide guidance to life insurers on the tax aspects of new rules for reserves established by the National Association of Insurance Commissioners (NAIC). The Notice described the following interim conclusions about some of the issues identified in Notice 2008-18, that might result from the adoption of either AG-VACARVM or life PBR.

1. The Standard Scenario Amount (SSA) will be treated as a life insurance reserve for federal income tax purposes. For purposes of the reserve ratio test, the SSA is included in life insurance reserves as defined in Section 816(b) and in total reserves as defined in section 816(c).
2. For purposes of determining the statutory cap on reserves under section 807(d)(1), the term "statutory reserves" under section 807(d)(6) includes the SSA.
3. For purposes of determining the amount of the reserve under section 807(d)(2) with respect to a contract falling within the scope of AG 43 and issued on or after Dec. 31, 2009, the provisions for determining the SSA are taken into account. The provisions for determining the CTE amount are not taken into account.
4. If, with the consent of the state insurance commissioner, a company implements AG 43 over a period of up to three years, then the company must likewise implement the changeover to AG 43 over the same period of years for tax purposes.

This interim guidance is especially important for life insurers as they bring products to market in 2010. ACLI and its member companies understand the need to resolve other open issues and we are eager to work with the Treasury and the IRS as we have in the past on these reserve issues.

LIFE PBR

Our Company Tax Committee continues to review and analyze ACLI suggestions for the valuation manual for any potential tax issues. As the NAIC moves forward with consideration of the net premium floor, we will engage Treasury to continue consideration of the tax aspects of life PBR.

SEPARATE ACCOUNT DIVIDENDS RECEIVED DEDUCTION

ACLI also met with Commissioner Heather Maloy, the IRS Commissioner LMSB, and her staff as well as the Chief Counsel to discuss IRS exam issues affecting the life insurance industry. In that meeting, we had the opportunity to specifically focus on the audits of separate account dividends received deductions (DRD) and the adjustments which were being made without national office guidance. We were informed in the following week by the Director of Appeals that the Appeals Office intends to concede the outstanding DRD cases at Appeals. On May 20, 2010 Walter Harris, the industry director for Financial Services, issued an Industry Director Directive (IDD) in which he referenced favorable technical advice memoranda issued in 2000 and 2002 as consistent with section 812 and which states that Treas. Reg. § 1.8101-8(e)[1] describes the method to be used in computing DRD.

The goal of the Commissioner and the ACLI is to have a regular dialogue on significant industry issues. The Commissioner and her staff have established informal groups with other industries. We think that this initial meeting was a good first step in establishing an improved dialogue between the IRS and the life insurance industry.

HEALTHCARE BILL—MEDICARE CONTRIBUTION INVESTMENT TAX

On the legislative front, in March a "Medicare Contribution Investment Tax" was passed as part of the reconciliation bill. This provision imposes a 3.9 percent tax on the "net investment income" of individuals earning more than $200,000

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and couples earning more than $250,000. "Net investment income" was defined to include income from annuities; income from interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business) were also included in the definition of investment income. Income from qualified annuities is not subject to the tax; such income however is taken into account in determining the threshold income amounts of $200,000 and $250,000 for single and married individuals respectively. ACLI worked with the Administration and legislators to develop an exception for income from qualified annuities to avoid additional taxes on the retirement income of Americans who planned responsibly for their retirement needs.

FINANCIAL CRISIS RESPONSIBILITY FEE — BANK TAX

The Financial Crisis Responsibility Fee ("Bank Tax"), as originally described in the Administration's Fiscal Year 2011 Budget, would impose a fee of 15 basis points on the consolidated liabilities of financial firms with consolidated assets of $50 billion on banks, thrifts, bank or thrift holding companies, brokers, and securities dealers as of Jan. 14, 2010. While as described, the proposal seems to be aimed at banks and broker-dealers, the description that includes "U.S. companies owning or controlling these types of entities" causes concern for insurance companies.

On May 4, 2010, AEGON Chairman Pat Baird testified on behalf of ACLI before the Senate Finance Committee as it took up the Bank Tax. His testimony and comments made it clear that imposing a tax on life insurers with banks or thrifts or broker-dealers is not consistent with the stated goals of the proposed tax: to repay the federal government for costs it incurred during the financial crisis, and to deter excess leverage for the largest financial firms. In a prior panel before the Committee, Secretary Geithner testified about the proposed fee and members raised a number of concerns about the tax, including a request that the tax should not be applied to an insurer that owns a small broker dealer or a bank. The Secretary indicated a willingness to consider other approaches to the tax and referenced "risk weighted assets."

ACLI and its members and their representatives continue to meet with members and key staff from the House and Senate Tax Committees to voice our strong opposition to including life insurers in the scope of the proposal. Our Company Tax Committee will continue to analyze and prepare responses to any other approaches suggested by Treasury or the tax writing committees.

END NOTE

[1] *See*, TAM 20003808 (Jun. 13, 2000) and TAM 200339049 (Aug. 20, 2002)

PRODUCT TAX SEMINAR

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T³: *TAXING TIMES* TIDBITS

KARL L. MATTHIES AND DEBORAH MATTHIES V. COMMISSIONER, 134 T.C. NO. 6, FEBRUARY 22, 2010

By Christian DesRochers

A recently-decided Tax Court case dealt with the continuing issue of the value of a life insurance contract distributed from a qualified pension plan.[1] The case does not break any new ground, and deals with the valuation of a life policy before the changes made in 2005 to the section 1.402 regulations, but is interesting in the approach applied by the Tax Court to define "cash surrender value," under the pre-2005 version of regulations.[2]

The case dealt with a transaction under a Pension Asset Transfer (PAT) plan, which was promoted to the taxpayers to "transfer qualified pension assets or IRA dollars to the participant or the participant's family without significant taxation." Under the PAT plan, a life insurance policy purchased inside a retirement plan is subsequently transferred to the client, with any tax paid on the value of the policy at the time it is distributed. At the time of the transfer in December 2000, the policy had an account value of $1.368 million, subject to a $1.062 million surrender charge, resulting in a cash surrender value of $306K. As consideration for the policy, the taxpayer transferred $315K to the profit sharing plan. No income was reported on the sale of the policy.

Subsequently, in January 2001—and as part of a pre-arranged plan—the policy was transferred to a family trust and exchanged, with the same carrier, for a single premium policy with a premium exactly equal to the $1.368 million account value. However, the replacement policy provided for no surrender charge.

Faced with this set of circumstances, the Internal Revenue Service (the "Service") determined that the taxpayer had under reported gross income on the sale equal to the $1.368 million account value, less the consideration of $315K, a net of $1.053 million, approximately equal to the surrender charge of $1.062 million, and imposed an accuracy-related penalty under section 6662(a).

The essence of the case was whether in valuing the life insurance policy a reduction should be made for the surrender charge. That is, the Service argued that the fair market value of the policy was the $1.368 million account value, so that there was a $1.053 million bargain element of the sale, while the taxpayer argued that the basis of value should be the interpolated terminal reserve of $306K reported by the carrier, so there was no bargain sale.[3]

Aside from the factual determination of the value of the policy, there was also a discussion of the applicability of the revised section 402(a) regulations, which were being revised in 2005, as well as the applicability of the section 402(a) regulations generally, as the transaction was not a distribution, but a sale.

In its opinion, the Tax Court agreed with the Service on the valuation of the policy, but arrived at their conclusion under the pre-2005 regulations. Noting that the previous regulations, finalized in 1956, referred to the "entire cash value" of the contract, the Tax Court looked to the section 72(e)(3)(A)(i) and 7702(f)(2)(B) definitions of cash surrender value, as the value "without regard to any surrender charge," commenting that "we do not believe that the appearance of the adjective 'entire' before the words 'cash value' in the applicable regulations can sensibly be read to connote any lesser value than 'cash value' under section 72(e)(3)(A) or 'cash surrender value' under section 7702(f)(2)(A)." While holding for the Service, the Tax Court also held that the taxpayers had a reasonable basis for their return position and did not hold them liable for the penalties.

While the decision was not surprising, the Tax Court has to get some credit for creativity in reading a regulation in the context of a statute, in the case of section 7702, that was enacted almost 30 years after the regulation was finalized. Given the facts of the case, a simpler approach would have been to recognize the value of the exchanged policy, which was equal to the $1.368 million account value, as indicative of the fair value of the original contract.

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END NOTES

[1] For background, *see* "Determining the Value of a Life Insurance Contract: Revenue Procedure 2005-25;" *TAXING TIMES*, December 2005. *See also*, "T.D. 9223 Value of Life Insurance Contracts When Distributed from a Qualified Retirement Plan," I.R.B. 2005-39, September 26, 2005.

[2] Revenue Procedure 2005-25 applies to distributions, sales and other transfers made on or after Feb. 13, 2004. However, for periods before May 1, 2005, taxpayers may rely on the Rev, Proc, 2005-25 safe harbors. For periods on or after Feb. 13, 2004, and before May 1, 2005, taxpayers may also rely on the safe harbors in Revenue Procedure 2004-16. Revenue Procedure 2005-25 provides that the safe harbor for nonvariable contracts may be measured as the greater of:
- The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the PERC amount and the applicable Average Surrender Factor.

The PERC amount is a formulaic accumulation of the premium less cost of insurance charges.

[3] The interpolated terminal reserve standard can be traced back to Revenue Ruling 59-195, which dealt with the sale of a policy to an employee. *See* Rev. Rul. 59-195, 1959-1 C.B. 18.

LATEST IRS INDUSTRY DIRECTOR DIRECTIVE ON THE DRD FOR LIFE INSURANCE SEPARATE ACCOUNTS MAY RESOLVE MAIN ISSUE, BUT DOES IT RAISE OTHERS?

By Susan J. Hotine

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For several years the life insurance industry and the Internal Revenue Service ("the Service") have conducted a vigorous dialogue about how to compute the company's share of net investment income from segregated asset accounts underlying variable contracts. The industry has contended that the company should use the prior-law formula set forth in Treas. Reg. § 1.801-8(e) ("the Regulation") as guidance for determining another appropriate rate to calculate required interest for separate account reserves; the Service generally has not agreed. The specific focus of this dialogue has been the determination of the company's share of dividends qualifying for the dividends received deduction ("DRD"). The context for this back-and-forth discussion has included the Service's examinations of taxpayers, administrative Appeals proceedings, and the process of issuing published guidance by the Service and the Department of the Treasury ("Treasury"). For example, initial Service guidance in the form of Technical Advice Memoranda favored use of the prior-law formula of the Regulation, until Rev. Rul. 2007-54, 2007-2 C.B. 604, came to a contrary conclusion, but the Ruling was suspended by Rev. Rul. 2007-61, 2007-2 C.B. 799, in response to industry criticism.

There are signs the dialogue is working toward a conclusion. Beginning in early May of this year, taxpayers began hearing that the IRS Appeals Division is prepared to concede the issue. Then, on May 20, 2010, Walter Harris, the IRS Industry Director for Financial Services, issued an Industry Director Directive (LMSB Control No.:LMSB-4-0510-015) regarding the examination of the DRD in connection with separate accounts of life insurance companies. The May 20 Directive (in tax jargon, an "IDD") appears to adopt the industry position, although notably the Directive does not use the word "concede," and so its message is less clear than it could be.

The May 20 Directive is a revised version of an IDD with the same control number that was issued on May 17, 2010. The two key clarifications of the revised Directive are significant. First, in the "Discussion" section, the May 20 Directive adds a sentence to affirm, "With respect to calculating the company's share of a separate account's net investment income, Treas. Reg. § 1.801-8(e) sets forth a formula to be used in computing required interest at 'another appropriate rate.' See TAM 200038008 (June 13, 2000) and TAM 200339049 (Aug. 20, 2002)." Second, in the "Risk Analysis" section, in advising agents that the DRD issue should be raised if the company uses a method for computing the company's share of investment income that is inconsistent with section 812 and Treas. Reg. § 1.801-8(e), the Directive now refers to " Treas. Reg. § 1.801-8(e) (as illustrated by TAM 200038008 and TAM 200339049)." Thus, the May 20 Directive acknowledges that the two TAMs properly apply the formula of the Regulation to determine another appropriate rate for calculating required interest for separate account reserves and for computing the company's share of a separate account's net investment income.

But the message of the Directive is obscured somewhat because it does not plainly state that Rev. Rul. 2007-54 is incorrect. Nevertheless, this is the implication of the Directive, which notes (again in the "Discussion" section) that Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61 and approvingly cites the two TAMs, which are inconsistent with the suspended Ruling. The Directive also refers to the statement in Rev. Rul. 2007-61 that the Service and Treasury intend to address the issues considered in the suspended ruling in regulations and, "until such time, the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued." However, in the past four years, similar language in Rev. Rul. 2007-61 has been read by some in LMSB as allowing agents to use the analysis set forth in Rev. Rul. 2007-54, but not allowing them to cite Rev. Rul. 2007-54 as authority.

The May 20 Directive supercedes prior direction to the field in an IDD issued April 22, 2008 (LMSB Control No.: LMSB-

04-0308-010) and an issue Alert issued by the Service on July 15, 2009. However, the Directive suggests two new avenues for agents to explore in examining the DRD issue. First, it states that agents should examine multi-year comparisons of the DRD computation and determine if the company has changed its method for calculating the DRD. The Directive instructs that, if over several years there is a significantly higher company's share of net investment income, an information document request should be issued asking for the reasons for the change, as well as for a comprehensive explanation of the company's method of computing the DRD before and after the change, together with detailed computations on a separate account basis. Second, the Directive states that agents should review the computations and determine whether the facts represented in the life insurance company's computation methodology are consistent with the company's reporting for financial and state law purposes. It states that agents should issue an information document request for the company's original application for separate account treatment submitted to the state insurance department to verify that the company's treatment of the separate account is consistent with the definition under state law.

It is not clear what issues the Directive has in mind in suggesting these new inquiries. Although the change-in-methodology inquiry does sound as though some in LMSB think there are accounting method change issues to be explored in the DRD computation, IRS representatives at the FBA Insurance Tax Seminar last June indicated otherwise. But, then, to what kind of change issues are agents being directed? Does the inquiry regarding the financial and state reporting for separate accounts mean that there is a concern that companies are treating assets as segregated in variable contract separate accounts for tax purposes that are not so segregated for state law purposes? Or, are the new inquiries just an attempt to encourage agents to examine whether a company is correctly applying the formula of the Regulation for calculating required interest for separate account reserves for variable contracts? The TAMs cited in the Directive address some of the issues for application of the Regulation formula in the context of current law, but perhaps not all.

Like the IDD and Alert that it supercedes, the May 20 Directive states that the DRD issue of life insurance companies is not a mandatory examination item but, if the agent's Risk Analysis indicates that the issue is material, it should be developed. It also continues to encourage agents to communicate and collaborate with IRS Local Counsel, as well as LMSB life insurance actuaries.

IRS ACTUARIES RAISING NEW ISSUES ON AG 34 TAX RESERVES

By Peter H. Winslow

With the assistance of Internal Revenue Service ("IRS") actuaries, IRS agents are routinely raising a new issue for tax reserves held under variable annuity ("VA") contracts that provide guaranteed minimum death benefits ("GMDB"). Prior to being superceded by Actuarial Guideline XLIII ("AG 43") effective Dec. 31, 2009, statutory reserves for VA contracts with GMDB were required to be computed under Actuarial Guideline XXXIV "Variable Annuity Minimum Guaranteed Death Benefit Reserves" ("AG 34"). Under Notice 2010-29,[1] AG 34 will continue to apply as the tax reserve method for most contracts issued prior to Dec. 31, 2009, because it is the applicable interpretation of CARVM prescribed by the NAIC in effect on the date of the issuance of the contract.[2]

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AG 34 requires the calculation of an Integrated Reserve that combines GMDB with other contract benefits under various benefit streams. These benefit streams take into account an assumption that account values will grow by "a return based on the valuation rate less appropriate asset based charges." Life insurance companies generally have recomputed their AG 34 tax reserves by starting with statutory AG 34 reserves and substituting the discount rate prescribed in section 807(d)(4) (generally the applicable federal interest rate or "AFIR"). Then, a conforming adjustment is made to the account value projection rate to comply with the CARVM requirements specified in AG 34. The audit adjustment currently being proposed by IRS actuaries is to eliminate the tax reserve adjustment for the projection rate and require the rate to remain at the statutory valuation rate less asset based charges. No adjustment is proposed by the IRS agents to the AFIR discount rate used for tax reserves. IRS agents have offered the following arguments to support the position that tax reserves should use the statutory rate for the earnings assumption while at the same time using the AFIR discount rate:

1. The reference in AG 34 is to the statutory valuation rate, not to the valuation rate prescribed for tax reserves;

2. The projected future benefits assumed in computing tax reserves should never exceed the future benefits assumed in statutory reserves;

CONTINUED ON **PAGE 54**

3. An adjustment to the earnings rate is inconsistent with how tax reserves are computed for fixed annuities where no tax adjustment is made to the statutory earnings rate;

4. The interest rate adjustment required for tax reserves is intended to apply only to the discount rate, not for other interest rate assumptions; and

5. Congress could not have intended that tax reserves, as recomputed under section 807(d), exceed statutory reserves, which would be the case mathematically if the projection rate is adjusted to conform with the AFIR.

Strong counterarguments could challenge each of these points. This is a tax reserve method issue, not solely a discount rate issue. By its terms, AG 34 specifies that the forward-rate earnings assumption on account values must be based on the valuation rate (*i.e.*, the discount rate for reserves). Once the valuation rate for tax reserves is adjusted to comply with section 807(d)(2), AG 34 mandates that the forward-rate earnings assumption be conformed to the same valuation rate. Otherwise, there would be an impermissible mismatch in earnings and discount-rate assumptions that violates AG 34. Moreover, Congress prescribed the use of CARVM for tax reserves for annuity contracts. To the extent that leads to tax reserves greater than statutory reserves, they are capped. Thus, Congress contemplated that a tax-reserves-greater-than-statutory-reserves situation could occur and that the tax deduction should be limited accordingly. Further, projected benefits on fixed annuities generally are the same for tax and statutory reserves because the forward earnings rate is guaranteed by contract. The same is not true for variable contracts. Unlike fixed contracts—in the case of variable contracts the forward earnings rate is not guaranteed—the future benefits reflect the market value and investment return on the underlying assets, less expenses. AG 34 requires consistency in reserve assumptions between the discount rate and the forward earnings rate for the Integrated Reserve.

It will be interesting to see how this new proposed IRS agent position plays itself out as tax return audits mature and the issue goes to IRS Appeals. ◂

END NOTES

[1] 2010-15 I.R.B. 547.

[2] *See* I.R.C. § 807(d)(3)(B).

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