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## XXX Reserve Funding is Debt for Federal Tax Purposes

By Seth L. Rosen and Arthur C. Schneider<sup>1</sup>

**B**efore the onset of the current capital markets crisis, the market for “insurance-linked” securities (“ILS”) had been experiencing rapid growth. ILS is a generic name for a number of innovative market solutions that have allowed insurers to access capital markets funding for various purposes. These transactions, which have tapped both bank and capital markets sources for financing, are often referred to as “securitizations.” Over the years, there have been a number of insurance industry securitization transactions including closed block securitizations, embedded value financings, and the issuance of catastrophe or mortality bonds.

Among the most common life insurance industry capital markets funding transactions have been “XXX” reserve financings, and those transactions are the subject of this article.

On several occasions in the past two years, officials from the Internal Revenue Service (“IRS”) have indicated publicly that they are studying issues relating to the federal income tax treatment of XXX reserve financings. In August 2008 officials of the IRS and United States Treasury Department (“Treasury”) met with industry representatives to discuss common structures for the transactions. While IRS officials have recently indicated that they continue to study the issues, no official guidance has been issued.

As discussed below, the key to understanding the appropriate federal income tax treatment of typical XXX reserve financings is to understand that they are structured so that lenders providing the financing take on risk of loss commensurate with highly rated investment grade debt and

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are compensated accordingly. Thus, under the case law relating to the tax treatment of surplus notes and general tax law principles distinguishing debt from equity, securities issued in typical XXX reserve financings are appropriately treated as debt for federal income tax purposes. As discussed in more detail below, this result is entirely consistent with the economics of the transactions, and the financial expectations of the participants in the transactions, because the investors in XXX securitizations are taking on credit risk and not insurance risk.

### BACKGROUND ON REGULATION XXX AND LEVEL PREMIUM TERM INSURANCE

Regulation XXX is the short-hand name for the Valuation of Life Insurance Policies Model Regulation issued by the National Association of Insurance Commissioners (“NAIC”). This regulation prescribes the Commissioners’ Reserve Valuation Method (“CRVM”)<sup>2</sup> applicable, with some exceptions, to all life insurance policies issued on and after Jan. 1, 2000. However, it perhaps most significantly impacts long-duration term life insurance contracts with a period of guaranteed level premiums (“level premium term”).

Level premium term, which generally provides term life insurance coverage renewable to a certain age, has in recent years been the most popular form of term life insurance. As its name implies, the premiums for a level premium term policy remain the same for a specified period of years. After that time, the contract is typically renewable at higher premium rates that may not be guaranteed. So, importantly for reserve calculations, level premium term does not have level premiums for the duration of the contract. Level premium term is typically used for life insurance needs that do not exist for the whole of a policyholder’s life – *e.g.*, the need for coverage while children are dependent. The advantage to the policyholder is in having a contract with affordable premiums that do not increase during the guaranteed period.

Prior to Regulation XXX, reserves for level premium term contracts could be determined on a unitary basis by taking into account the higher (often much higher) premiums to be charged beyond the guaranteed period, even though such premiums were generally not expected to be, and in many cases were not, paid. Effectively, for reserving purposes, premiums from beyond the guaranteed period were being used to fund benefits during the guaranteed period.

Under Regulation XXX, basic reserves are the greater of segmented reserves or unitary reserves. Segmented reserves are calculated using periods of time (“segments”) produced by

the contract segmentation method, which divides the duration of the contract into successive segments. Essentially, the contract segmentation method requires that net premiums within each segment fund the death benefits arising within that segment. Unitary reserves, on the other hand, are calculated by taking into account guaranteed benefits and modified net premiums for the entire duration of the contract. Deficiency reserves may also be required to be held.

While all reserving requirements for NAIC-based financial reporting (“statutory accounting”) are generally conservative to reflect the solvency concerns of state insurance regulators, it is generally acknowledged that XXX reserving requirements are exceptionally conservative, resulting in extraordinary strain on the capital of companies that write level premium term business. The strain arises primarily because the net premiums used in the determination of reserves under the contract segmentation method required by Regulation XXX are based on more conservative assumptions relating to mortality, interest, and lapsation than the assumptions used in pricing or in an economic best estimate of the net future liability.<sup>3</sup>

### FINANCING XXX RESERVE CAPITAL STRAIN

As with any reserve requirement, this is essentially a long-term timing issue—reserves grow in the early years to an amount that exceeds the expected economic liability by a substantial amount, then decline for a long period of years until the required regulatory reserves and the economic best estimate of the insurer’s net future liability are the same.

In the meantime, the statutory capital strain must be funded. The strain could, of course, be funded through retaining or increasing statutory capital and surplus. However, the financial returns of a life insurance company, like any business, can be enhanced by leveraging the cost of capital. In the case of level premium term insurance, the discontinuity between the regulatory reserves and the perceived economic liability created a market opportunity for life insurance companies to reduce their cost of capital by borrowing from banks or capital markets to fund their XXX reserves.

Initially, life insurance companies used reinsurance to help fund the reserving requirements imposed by XXX, but reinsurance markets tightened and letters of credit needed for off-shore solutions (and which, in any event, generally did not match the duration of the financing need) became less available and more expensive. To fill this void, banks and the capital markets in general stepped in with innovative financing alternatives.

## ACTUARIAL MODELING AND STRESS TESTING

The key to the XXX funding structures is that actuarial models can be built to demonstrate (using a wide range of deterministic and stochastic scenarios) that with an appropriate capital cushion there is a very high likelihood that loans to fund XXX reserves will be repaid. Using the model, the business can be subjected to extensive stress testing to satisfy all parties that the likelihood of repayment is commensurate with high investment grade (*e.g.*, AA) debt.

Investment grade credit ratings are achieved by providing a very high degree of comfort that cash flows relating to the business (as further supported by equity capital) are more than adequate to service the required payments on the debt financing. Stress testing of the actuarial model determines the equity capital requirements needed to provide investment grade levels of assurance that the structure not only supports repayment of the debt, but is capable of absorbing reasonably expected, or even extreme, adverse developments in the business. Furthermore, because assets held to fund the reserves are subject to regulatory requirements, investment parameters can be set to control asset risk.

As noted above, stress testing uses deterministic and stochastic scenarios, and involves both actuarial assumptions (*e.g.*, mortality and lapse) and asset assumptions (*e.g.*, earnings rates and default rates). These assumptions are stressed separately and in combination. For example, mortality might be stressed by adding a factor (*e.g.*, 20 percent) to estimated mortality rates. Or lapsation might be stressed by adjusting a baseline lapse rate (*e.g.*, 2 percent) up or down (*e.g.*, +/- 50 percent). Another variation of mortality stress might be to assume a one-time catastrophic shock (*e.g.*, a three times mortality event) in a particular year. The possibilities are nearly endless, but all these stresses are selected to facilitate the determination of a level of equity capital commensurate with AA or higher debt ratings.

As a result, lenders in these transactions do not see themselves as taking on insurance risk, but rather as taking high investment grade debt risk.<sup>4</sup> Accordingly, XXX reserve funding can be accomplished at reasonable interest rates commensurate with investment grade commercial lending. This is, of course, attractive to life insurance companies that write level premium term business because such borrowing can be used to lower the cost of capital required to fund XXX reserves, and thereby improve financial returns and allow a greater volume of new business.

## ISOLATION OF XXX BUSINESS IN A WELL-CAPITALIZED CAPTIVE REINSURER

The modeling and stress testing of a block of XXX business assumes that the business is isolated from the life insurer's other business. This assumption enables lenders and rating agencies to perform due diligence on the isolated cash flows. Therefore transactions have been structured to achieve this isolation through reinsurance to a special purpose captive reinsurer.<sup>5</sup> Isolation of business in an appropriately capitalized captive reinsurer provides assurance to lenders that they will be repaid out of the cash flows emerging from the block (as supported by the equity capital cushion) without running the risk that those cash flows will be absorbed by unrelated liabilities of the ceding company. Accordingly, the perceived risk (and rating of the debt) can be based on an analysis of the cash flows and capital within the isolated structure, and not on the general creditworthiness of the direct writer.

In summary, the key to successful XXX reserve funding transactions has been 1) modeling to show that lenders are not exposed to insurance risk but rather are lending on a highly-rated investment grade basis; 2) adequate capitalization to assure lenders, rating agencies, monolines, investment banks, etc. that 1) was true; and 3) isolation of the cash flows through reinsurance into an appropriately capitalized special purpose captive reinsurer.

## TAX CONSOLIDATION OF CAPTIVE REINSURER RESULTS IN TAX NEUTRALITY

From a federal income tax perspective, XXX transactions are structured to achieve tax neutrality. That is, XXX financing transactions do not create tax losses or excess tax deductions, but simply preserve the group's tax position, in the same manner as if the direct writer had retained the XXX business on its own balance sheet.

In general, tax neutrality is achieved as long as both the ceding company and the captive reinsurer are members of the same affiliated group. Because the captive reinsurer will sustain a tax loss in the initial year of the transaction (and generally for a number of subsequent years), it is usually essential that the captive and ceding company be members of the same life-life or life-nonlife consolidated return group from day one. Tax consolidation is appropriate and consistent with the underlying economics of the transactions. In XXX financings, the ceding company's consolidated group generally provides the equity capital, described above, that protects lenders' repayment expectations, in exchange for common stock.

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As the equity owner bears the risk of loss from extraordinary events, it also has the opportunity for gain. Unlike the lender, which (as described below) will receive a fixed return on its investment, the residual equity interest evidenced by the common stock will be worth more or less depending upon the success or failure of the reinsurer's business. Thus, the holder of the common equity is appropriately treated as the controlling shareholder for purposes of IRC section 1504.

Where the captive reinsurer can be established as a subsidiary of another life company that is not a member of a life-nonlife consolidated return, consolidation is rather straightforward. Where, however, it is desired to include the captive reinsurer in a life-nonlife consolidated return, it is necessary to rely on the "tacking rules" of Treas. Reg. § 1.1502-47(d)(12)(v), which "tack" the membership period of an "old" life company member of the group onto a newly-formed life company. Without tacking, the captive reinsurer would be unable to join the life-nonlife return for a period of five years.

While a discussion of the tacking rules is beyond the scope of this article, one point is especially worth noting. In order for tacking to apply, four conditions must be satisfied. Prior to 2006, there was a fifth condition which provided that a transfer from the "old" life company to the new one not be reasonably expected to result in the separation of profitable activities from loss activities. Life insurance industry submissions had been made to the Treasury urging repeal of this separation condition specifically to accommodate XXX funding transactions.<sup>6</sup> While the preamble to the regulations which deleted the separation condition did not specifically mention XXX transactions, it is undeniably true that the Government was aware that the change would facilitate XXX funding.

The tax neutrality achieved in the initial year of the transaction continues throughout the life of the XXX reserve funding transaction, so long as consolidation of the captive reinsurer is maintained. In other words, the same reserve deductions and the same taxable income emerging as reserves increase and decrease that would have been reported by the direct writer are reported in the consolidated return that includes both the ceding company and the reinsurer. The purpose of XXX reserve funding transactions is to provide cost-effective regulatory capital for life insurers—the transactions themselves do not create or increase tax reserve deductions. There are, of course, tax deductible interest deductions relating to the debt incurred in the transaction. But as with the reserve deductions, those interest deductions are no different than those that would be allowed if the direct writer had been the borrower.

For the captive reinsurer to meet the ownership requirements for tax consolidation, the debt issued to finance the reserve requirements must be treated as debt for federal income tax purposes.<sup>7</sup> In fact, the key to XXX funding transactions from a tax perspective is the treatment of the bank or capital market financing as debt for tax purposes. In turn, the key to the conclusion that the funding is debt is the modeling of the block and the adequacy of the capital buffer. That is, it must be demonstrable that the investors are taking creditor risk typical of lenders who buy investment grade paper, and that they therefore are not taking the entrepreneurial risk that is the hallmark of equity.<sup>8</sup>

### DESCRIPTION OF COMMON STRUCTURES

The diagrams on page 9 illustrate two common structures for XXX reserve funding transactions.<sup>9</sup> The first is a "private" transaction in which a bank provides financing to the captive reinsurer and receives "surplus notes" in exchange. As discussed below, surplus notes are treated as debt for federal income tax purposes, but are includable in capital for statutory accounting purposes. In this structure, a parent life insurance company forms the captive reinsurer and contributes equity capital in an amount dictated by the results of the financial modeling. The bank then purchases surplus notes from the reinsurer. The parent or an affiliated life insurance company (the direct writer) then cedes XXX business to the reinsurer. This business is collateralized by amounts held in a trust so that the direct writer is allowed a reinsurance reserve credit on its statutory financial statements. Generally, a rating agency would be involved—perhaps to issue an explicit or shadow rating on the notes, but certainly to ensure that the notes receive operating leverage treatment. The structure may provide for periodic review of reserves and capital adequacy, and may provide restrictions on dividends from the captive reinsurer. Typically, some type of parent company credit support would be required. All of this is, of course, subject to approval by the appropriate state insurance regulators.

The second transaction is similar, but illustrates a transaction with the broader capital markets. In this case, a trust purchases the surplus notes, and the public creditors purchase trust certificates.<sup>10</sup> Prior to the financial crisis, the trust certificates would have been wrapped by a monoline financial guaranty insurance company to enhance the credit rating of the debt issuance to an AAA level.<sup>11</sup> Similar to the first structure, there would be rating agency involvement, and the other structural features designed to ensure adequate cash flows to fund the required interest and principal payments on the debt would be present. (*Refer to diagrams on page 9.*)



**TERMS OF THE SURPLUS NOTES**

As noted above, XXX financings typically have taken the form of surplus note offerings, because they provide capital for statutory accounting purposes. The notes have a stated maturity tied to the expected development of the block—typically 20 to 30 years—and provide for periodic payments of stated interest. Interest payments may be fixed or variable based on an objective index, but the interest rate is not based on the profits or other results from operations of the issuer.

Usually, there is no sinking fund for repayment of principal prior to maturity, but frequently profits emerging from the block must be applied to pay down the debt as they emerge (so-called “flexible amortization” notes). As a result the “weighted average life” of the notes is usually expected to be substantially less than the stated maturity under the modeled “base case” scenario and other reasonably expected scenarios for the development of the block. However, the lender usually has no right to be repaid before stated maturity.

Generally, for the notes to qualify as surplus notes for statutory accounting purposes all payments of interest and principal require as a matter of state law prior approval or non-disapproval of state insurance regulators based upon a showing that following the payment the borrower will have adequate capital and surplus. Ultimately whether or not stated payments can be made is generally a matter of regulatory discretion. In most transactions, the reinsurer issuing the surplus notes covenants to use a high level of effort to obtain regulatory approval. Failure to exert the requisite degree of effort to secure consent is usually not an event of default that can accelerate the notes, but can result in a suit for damages.

Other common characteristics of surplus notes dictated by statute or regulations include:

**Deep Subordination**

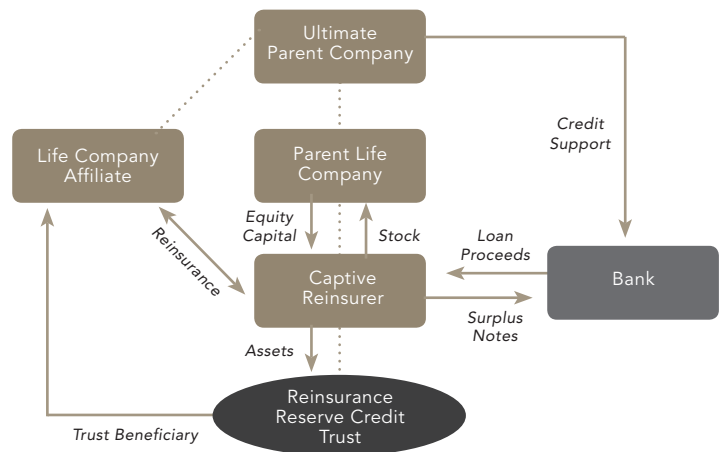
In the event of the liquidation of the issuer, surplus notes will rank senior to equity in priority of payment, but subordinate to all payments to policyholders, debts for borrowed money (other than other surplus notes) and trade creditors.

**Limited Creditors’ Remedies**

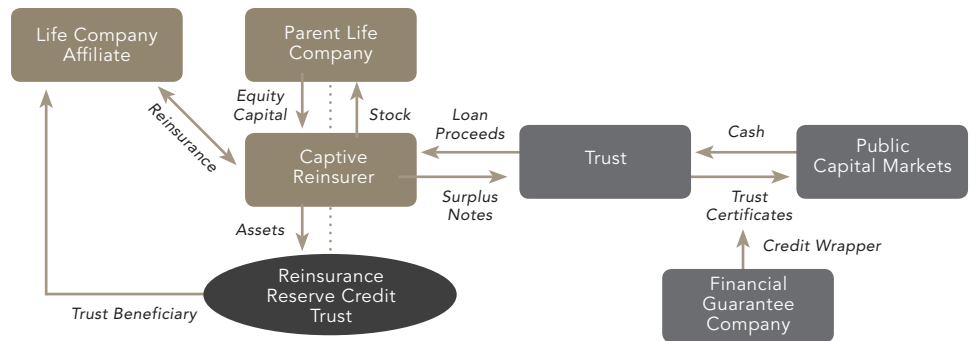
Regulatory approval is necessary to make payments on surplus notes

even if an event of default has occurred that would result in an acceleration of payment obligations under more typical debt. Moreover, if regulatory approval for scheduled payments of principal and interest is not received, a failure to pay will not result in an acceleration of principal. In that event interest will continue to accrue on the unpaid principal amount, but “interest on interest” will not accrue. Breach of a non-payment covenant—including a failure to use required efforts to obtain regulatory approval for payments—can result in a suit for damages, but not in acceleration of the debt.

**PRIVATE XXX FUNDING TRANSACTION**



**CAPITAL MARKETS XXX FUNDING TRANSACTION**



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An acceleration can occur, however, if payments of interest and principal are not made after regulatory approval is received or if there is a bankruptcy event with respect to the ceding company, the reinsurer or (sometimes) their affiliates. Despite the acceleration, no payments can be made without regulatory approval.

### TAX ANALYSIS OF SURPLUS NOTES

The most important element of the tax analysis of notes issued in XXX financings is the parties' understanding of the results of the financial modeling described above. That is, under the base case and a full range of other scenarios that can be reasonably expected to occur (except occurrences the possibility of which are remote) during the term of the debt, are the notes expected by the issuer and investors to be repaid in accordance with their terms?

Stress testing will result in a relatively high investment grade rating and treatment as operating leverage, indicating confirmation by the independent rating agencies that the debt is highly likely to be repaid in accordance with its terms from the operating cash flow produced by the reinsured block, as supported by an appropriate equity capital buffer, under all reasonable scenarios. In other words, based on adequate capitalization of the issuer and rigorous analysis of the model, the issuer and investors agree that regardless of the occurrence or non-occurrence of insurance risks the investors are highly likely to be paid all interest and principal due under the notes.

The capital elements of a typical XXX financing can be contrasted with the securitization of natural catastrophe risk via catastrophe-linked ("CAT") bonds. CAT bonds are typically structured so that if a catastrophic loss occurs from one or more specified insurance events the CAT bond investors bear the burden of the loss. In the typical CAT bond transaction an insurance company enters into a risk transfer contract with an offshore Special Purpose Vehicle ("SPV"). The SPV issues "notes" to investors in the capital markets and the proceeds are invested in securities and held in a collateral trust. Assets held in the collateral trust may be drawn upon by the insurance company in the event of occurrence of the specified contingency. Unlike the reinsurer in a XXX financing, the SPV in a CAT bond structure is not capitalized with funds beyond those contributed by capital markets investors. Accordingly, the parties to the transaction fully expect that losses will pass through to the investors.

As a result, the investors are treated for federal income tax purposes as equity owners of the SPV. Thus, a CAT "bond" is really CAT "equity," because it transfers the risk of insurance losses to the SPV investors. In contrast, losses incurred in a XXX financing structure are meant to be covered, even in stress scenarios, first by the cash flows from the underlying block of reinsured business, and then by the capital contributed by the sponsor in the structure. Only after these sources are exhausted do the investors bear any risk and, as noted above, their risk is that of a creditor in investment grade debt not that of an equity owner.

### STANDARDS APPLIED UNDER CASE LAW AND IRS RULINGS

"The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risk of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them."<sup>12</sup>

The IRC, regulations, case law and IRS rulings do not provide a bright line for distinguishing debt from equity. Instead, the case law and IRS pronouncements identify a number of economic and legal factors indicative of either debt or equity treatment, and the determination of whether an instrument should be treated as debt or equity turns on the presence or absence of a predominance of those factors. No one factor is determinative, and the importance of each factor to the analysis is determined based on the facts and circumstances of each case.

The factors identified by the IRS and the case law are all intended to illuminate the central question described above: To what extent did the purported debtor and creditor intend to create (and in fact create) either a debtor/creditor relationship—in which the investor does not participate in the risks and rewards of the issuer's business—or an equity holder's relationship—in which the investor takes on the entrepreneurial risk inherent in the business in exchange for the possibility of greater reward if the business is ultimately profitable.

As described above, surplus notes have a number of characteristics that are normally considered to be indicative of equity for federal income tax purposes. However, courts have uniformly held that the existence of these characteristics does not prevent

surplus notes and similar instruments that are issued by an insurance company, in compliance with the state regulatory regime applicable to the issuer, from being treated as debt for U.S. federal income tax purposes. Instead, the courts have looked to other factors traditionally considered by the IRS and the courts to determine whether the parties intended to create (and did create) a debtor/creditor relationship, despite the legal or regulatory restrictions imposed by state law or regulation. Thus, the courts have found surplus notes or similar instruments to be properly characterized as debt for federal income tax purposes despite the fact that the instruments in question were subordinated to all of the company's other indebtedness; were issued proportionately to equity owners; lacked a fixed maturity date because principal payments were linked to surplus levels; required regulatory approval for payments; or were payable solely in the discretion of the board.<sup>13</sup> Thus, the fact that the surplus notes issued in XXX financings include some equity-like characteristics mandated by state law and regulations should not affect the federal income tax analysis. In fact, as discussed in detail below, surplus notes issued in XXX securitization transactions typically have fewer equity-like characteristics than surplus notes that have been treated as debt by the courts.

The case law that has developed with respect to surplus notes recognizes that insurance companies can from time to time require substantial capital because of state law reserving and surplus requirements. State laws and regulations have developed an instrument—the surplus note—through which that required capital can be provided for a limited duration and be repaid when the capital is no longer needed. Where there is a high likelihood (and the parties clearly intend) that the borrowed capital will be repaid, the provider of that capital (the surplus note holder) does not share in the entrepreneurial risk inherent in the business and will typically accept and receive a rate of return on investment indicative of debt—a reasonable fixed rate of interest, or an interest rate based on an objective index, that is not in any way tied to the issuer's profit.

Thus, the courts that have considered the tax treatment of surplus notes have uniformly concluded that the surplus notes are properly treated as debt for federal income tax purposes where equity-like features were mandated by state law and the evidence indicated that the parties clearly intended to create, and did create, a debtor-creditor relationship.<sup>14</sup>

The IRS has not asserted a contrary position in published or private rulings.<sup>15</sup> For example, a 1996 written determination addressing the federal income tax treatment of surplus notes issued by a stock insurance company states:

[W]e anticipate that an attack on the surplus note would fail. Over the past 30 years, the [IRS] has attempted at least four times to defeat similar instruments. In each instance, the [IRS] failed to overcome the form of the transaction. An effort to repudiate the surplus note in this case would likely meet a similar fate. Not only can ... show that its notes possess characteristics of bona fide debt. It can also show a genuine business purpose for borrowing the funds. We recommend against adjusting the parties' returns as a result of this transaction.<sup>16</sup>

XXX securitization transactions are exactly consistent with the rationale that supports the tax cases and IRS authorities that have respected the treatment of surplus notes as debt. The insurer needs capital to satisfy state law XXX reserving requirements for a limited period of time. State law provides a mechanism for raising that capital and repaying it when it is no longer required. There is a high likelihood that the debt will be repaid, and the parties clearly intend it to be repaid in accordance with its terms. The lender receives a reasonable rate of return typical of a debtor/creditor relationship. Thus, each transaction should be analyzed based on recognized criteria for distinguishing debt from equity within the context of the existing surplus note authorities.

#### APPLICATION OF CRITERIA IDENTIFIED BY THE IRS TO DISTINGUISH DEBT FROM EQUITY

IRS Notice 94-47, largely following established case law precedents, lists a number of factors for the purpose of distinguishing debt from equity.<sup>17</sup> As described above, the analysis of whether surplus notes issued in XXX financings should be treated as debt for tax purposes should be based on the multi-factor test articulated in Notice 94-47 and identified by the case law and that is generally applicable to all debt instruments. However, case law clearly stands for the proposition that, in applying the multi-factor analysis, characteristics of surplus notes that might otherwise be treated as "equity like," but that are required to comply with state law or regulations applicable to the issuer, should not be treated as negative factors.

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The factors identified by Notice 94-47 are as follows:

### **An Unconditional Promise to Pay and Fixed Maturity in the Reasonably Foreseeable Future**

A fixed maturity date “in the reasonable future” at which time the holder can unconditionally require payment of a sum certain is a central element of the true debtor-creditor relationship.<sup>18</sup> While the term of surplus notes issued in XXX financings may be longer than that of many other debt offerings, it is still consistent with debt treatment.<sup>19</sup> Moreover, the duration of the debt is linked to the duration of the issuer’s need for the borrowed capital—the period during which the XXX reserve is expected to exceed the amount required to fund the expected payment pattern under the block.<sup>20</sup> In transactions with flexible amortization of principal, the amortization of the debt is tied directly to the decreasing need for capital. By contrast, equity usually has a longer term or is of infinite duration.

The interest payments on the surplus notes issued in XXX financings must be paid as scheduled, and all outstanding principal must be paid no later than the stated maturity, subject to regulatory approval or non-disapproval of payment. Although the possibility that payment might be delayed as a result of the approval requirement could be regarded as equity-like, i) the approval requirement is mandated by state law and typical of surplus notes that have been characterized by the courts as indebtedness, and ii) the issuer is generally under a contractual obligation to use significant efforts to secure consent and holders have the right to pursue legal remedies to enforce that obligation. Thus, the unconditional promise to pay a sum certain by a fixed maturity date in the reasonably foreseeable future, weighs in favor of characterizing surplus notes as debt, despite the fact that it is conditioned on regulatory approval of payment.

### **Right to Enforce Payment of Principal and Interest**

Holders of surplus notes in XXX financings have many typical creditors’ remedies in the event of non-payment or of the breach of covenants that do not involve payments. While the holders of the surplus notes do not have a right to accelerate maturity upon a failure to make a payment of principal or interest if due to failure to obtain required approvals, the lack of such a right, when required by state law or regulation, is not viewed as inconsistent with the treatment

of surplus notes as debt. Moreover, holders of surplus notes are generally entitled to other legally available remedies to enforce the terms of the surplus notes. Equity holders do not typically have such rights.

### **Subordination**

The subordination of a purported debt to other creditors is a strong indication that such debt should be treated as equity for federal income tax purposes. However, the authorities described above indicate that subordination should not affect the determination of debt or equity treatment in the case of surplus notes. Thus, while usually treated as an equity-like characteristic, the subordination of the surplus notes to the interests of other creditors is a neutral factor for characterizing the surplus notes issued in XXX financings as debt.

### **Participation in the Management of the Issuer**

Participation by a lender in the management of the borrower is a factor that would weigh in favor of treating an instrument as equity. Generally, surplus notes issued in XXX financings do not provide the holders with any rights to participate in the management of the issuer, beyond rights to vote on particular matters affecting their interests as creditors, or to protect the cash flows that are expected to pay debt service by ensuring performance under and enforcement of project documents in the event of non-payment or other default. These do not rise to the level of participation by holders in the management of the issuer that are indicative of an equity interest.<sup>21</sup>

### **Adequate Capitalization**

The issuer’s debt-to-equity ratio is a significant element in characterizing a purported debt instrument for federal income tax purposes.<sup>22</sup> The debt-to-equity ratio bears “on the reasonableness of the expectation of repayment, reflecting the extent of the cushion by which the purported creditors are shielded against the effects of business losses and declines in property values.”<sup>23</sup> No particular ratio is required by Notice 94-47, IRS rulings or case law. Rather the question is whether the equity cushion is adequate to protect the purported lender against a loss of principal (and required interest) in the event of reasonably foreseeable adverse developments. Courts have considered high debt-to-equity ratios to be acceptable for debt characterization purposes when the borrower could reasonably be expected to service the debt.<sup>24</sup>

In XXX transactions, as described above, modeling establishes a high likelihood that the notes will be repaid in accordance with their terms under all scenarios that might be reasonably

expected to occur—including stress scenarios that measure spikes or systemic increases in mortality, lapse rates and other relevant factors (including combinations of adverse factors). This analysis is often supported by ratings that characterize the notes as investment-grade debt and operating leverage, which indicate that an independent credit rating agency also believes there is a very high likelihood that the debt will be paid in accordance with its terms. The existence of objective indices that the equity provided in XXX structures is adequate to ensure payment in all reasonably foreseeable circumstances strongly supports debt treatment.

### Debt Holdings Proportionate with Holdings of Equity Interests

If a purported debt instrument is held in substantially the same proportion as the equity interests in the issuer, an inference arises that the debt instrument should be treated as equity, because there is frequently no economic consequence if proportionate shareholder advances are labeled as debt or equity. However, XXX debt holders are not controlling shareholders of the issuer.

### Denomination as Debt

Surplus notes issued in XXX transactions are denominated as debt instruments in all related documentation.

### Treatment for Nontax Purposes

Surplus notes are treated as debt for financial accounting purposes and as surplus notes for regulatory accounting purposes.

## ADDITIONAL SIGNIFICANT FACTORS UNDER CASE LAW

The courts have identified additional factors—beyond those articulated in Notice 94-47—that are deemed to be indicative of a debtor-creditor relationship. These include:

### Likelihood of Payment

A debtor-creditor relationship exists when the creditor expects full and timely repayment.<sup>25</sup> As described above, the high likelihood of full and timely repayment weighs in favor of characterizing surplus notes issued in XXX financings as debt.

### Adequate Interest

Failure to provide for an adequate interest rate evidences an attitude of a shareholder, not a lender.<sup>26</sup> The presence of an adequate interest rate weighs in favor of characterizing surplus notes issued in XXX financings as debt for federal income tax purposes.

### Participation by Note Holder in Success or Failure of Borrower

A high rate of interest—particularly if it is based on the profits of the borrower—could indicate that the holder of an instrument is primarily interested in participating in the earnings and growth of the borrower's business, which is an equity-like interest.<sup>27</sup> A high rate of interest may also indicate uncertainty concerning full and timely repayment. The interest rate on surplus notes issued in XXX transactions is not calculated by reference to the profits of the issuer; surplus notes are not convertible into equity of the issuer; do not provide for any payments other than principal and interest at a rate unrelated to the earnings and growth of the issuer's business; and do not include any other elements that would typically have the effect of lowering the interest rate on debt (*e.g.*, by allowing the purported creditor to share in the success of the issuer).

In summary, the factors identified by the IRS and the case law are intended to facilitate an analysis of whether the holder of an instrument denominated as “debt” is in the position of a true creditor, who expects to be paid out of the ordinary operating cash flows of the borrower, or an equity investor, who has assumed entrepreneurial risk. As applied to surplus notes (and other debt) issued in typical XXX financing transactions these factors establish that debt treatment is appropriate.

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As with any form of complex financial transaction, each XXX securitization transaction should be analyzed on its own terms. The analysis in this article discusses what the authors believe, based on their own experience and knowledge of the industry, to be typical financial terms. Where financial modeling and testing establish that there is a high degree of likelihood that the debt issued in XXX transactions will be paid in accordance with its terms—regardless of the occurrence or non occurrence of a verse insurance experience—then treatment as debt for federal income tax purposes is consistent with the form and underlying economics of the transactions, with the case law and with the IRS's own standards (as articulated in Notice 94-47). As a result, XXX securitization transactions should achieve the desired goal of “tax neutrality”—so that they can provide reasonably priced regulatory capital without changing the federal income tax consequences inherent in the underlying business. ◀

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## END NOTES

- <sup>1</sup> The authors would like to acknowledge that helpful comments were received from Nicholas F. Potter and Neil A. Dubnoff of Debevoise & Plimpton LLP.
- <sup>2</sup> The federally prescribed tax reserve under section 807(d) of the Internal Revenue Code ("IRC") follows the CRVM, with certain required adjustments.
- <sup>3</sup> A similar issue arises for reserves required with respect to secondary guarantees on universal life insurance contracts under Actuarial Guideline XXXVIII, The Application of the Valuation of Life Insurance Policies Model Regulation (often referred to as Guideline "AXXX"). However, structured solutions for AXXX reserve funding are similar to those used for XXX reserve funding, and AXXX funding is not separately discussed in this article.
- <sup>4</sup> Before the financial crisis, "monoline" financial guaranty insurers were sometimes involved in reserve funding transactions, essentially to lend their AAA credit ratings to the debt structure. The monoline's purpose was not to assume insurance risk, but rather to wrap its highest level investment grade rating around a lower rated (AA) debt financing. Typically, the monoline company would engage its own actuarial consultants to review the modeling and stress testing. In cases where the monoline was not satisfied with the results of the modeling, additional equity capital would be committed to the structure.
- <sup>5</sup> Several states, e.g., South Carolina, Vermont, and Delaware, have enacted statutes authorizing special purpose financial captives. These captive companies are insurance companies for state law purposes and are subject to regulation by the state insurance authorities.
- <sup>6</sup> See Letter from Lori J. Brown and Susan J. Hotine to Eric Solomon, Acting Assistant Secretary (Tax Policy), Department of the Treasury (July 13, 2005), 2005 TNT 145-26; Letter from Laurie D. Lewis and Mark A. Canter to Gerald B. Fleming, Senior Technical Reviewer, Internal Revenue Service and Mr. Solomon (Oct. 21, 2005), 2005 TNT 212-28.
- <sup>7</sup> Or, if treated as stock, then it must be so-called "plain vanilla" preferred stock as described in IRC section 1504(a)(4).
- <sup>8</sup> State special purpose financial captive statutes typically provide that a security issued by such a captive (or by a third party where the funds are then provided to the captive) is not subject to regulation as an insurance or reinsurance contract, and that an investor or holder of such a security is not considered to be transacting the business of insurance solely by reason of having an interest in the security.
- <sup>9</sup> While the diagrams illustrate a brother-sister relationship between the ceding company and the captive reinsurer, the parent life company also could be the ceding company.
- <sup>10</sup> In a variation on this structure, a limited liability company ("LLC") which issues its own debt certificates is interposed between the parent life company and the captive reinsurer. The LLC then makes a capital contribution of the proceeds of its debt issuance to the captive reinsurer.
- <sup>11</sup> The New York Insurance Department has ruled that the issuance of a financial guaranty policy in connection with a XXX transaction does not constitute the issuance of guaranties of life insurance and such activity is therefore not the conduct of a life insurance business by the financial guaranty insurer. In an opinion dated Oct. 17, 2005, the Department's Office of General Counsel stated: "[T]he financial guaranty company in a Regulation XXX transaction is simply providing a guaranty that the principal and interest payable to the purchasers of the Notes (which are 'investment grade') issued by the SPV will be paid by the SPV. The fact that the source of funds for the payments to be made on these bonds may be ultimately derived from a block of life insurance policies does not warrant a recharacterization of the financial guaranty policy in question since neither the SPV nor the purchasers of the Notes have any obligation to the insurer or the reinsurer should either be unable to meet its insurance obligations." (Emphasis added).
- <sup>12</sup> *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943); see also David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 Tax L. Rev. 499 (1995).
- <sup>13</sup> See, e.g., *Jones v. United States*, 659 F.2d 618 (5th Cir. Unit B Oct. 1981); *Anchor Nat'l Life Ins. Co. v. Comm'r*, 93 T.C. 382 (1989).
- <sup>14</sup> See *Harlan v. United States*, 21 A.F.T.R.2d 969 (N.D. Tex. 1968), *aff'd*, 409 F.2d 904 (5th Cir. 1969); *Union Mut. Ins. Co. of Providence v. Comm'r*, 46 T.C. 842 (1966), *aff'd*, 386 F.2d 974 (1st Cir. 1967); *Theodore v. Comm'r*, 38 T.C. 1011 (1962), *acq.*, 1966-2 C.B. 7.
- <sup>15</sup> See, e.g., Rev. Rul. 68-515, 1968-2 C.B. 297; TAM 199942005 (Oct. 25, 1999); TAM 9714003 (Apr. 4, 1997). Written determinations such as private letter rulings, technical advice memoranda and field service advice memoranda may not be used or cited as precedent. See IRC section 6110(k)(3). Nevertheless, "they may be cited as evidence of administrative interpretation." *True Oil Co. v. Comm'r*, 170 F.3d 1294, 1302 (10th Cir. 1999) (quoting *ABC Rentals of San Antonio, Inc. v. Comm'r*, 142 F.3d 1200, 1207 n.5 (10th Cir. 1998)).
- <sup>16</sup> 1996 IRS NSAR 5975 (also listed as 1996 FSA LEXIS 583) (July 30, 1996) (omission in original).
- <sup>17</sup> 1994-1 C.B. 357.
- <sup>18</sup> *John Kelley Co. v. Comm'r*, 326 U.S. 521, 526 (1946); see also *Wood Preserving Corp. of Baltimore v. United States*, 347 F.2d 117, 119 (4th Cir. 1965).
- <sup>19</sup> See, e.g., *Comm'r v. H.P. Hood & Sons*, 141 F.2d 467 (1st Cir. 1944) (40-year income debentures subject to subordination respected as debt); *Monon R.R. v. Comm'r*, 55 T.C. 345 (1970) (classifying 50-year subordinated income debentures as indebtedness because term was not unreasonable based on the facts and circumstances), *acq.*, 1973-2 C.B. 3; *Shannon v. Comm'r*, 29 T.C. 702 (1958) (49-year installment obligation for purchase of ranch respected); *Chas. Schaefer & Son v. Comm'r*, 9 T.C.M. (CCH) 1035 (1950) (50-year notes respected as debt because "[t]he time of maturity, while distant, was not unreasonable under the circumstances"); *Hemenway-Johnson Furniture Co. v. Comm'r*, 7 T.C.M. (CCH) 380 (1948) (30-year term respected), *aff'd*, 174 F.2d 793 (5th Cir. 1949); see also *Mountain State Steel Foundries, Inc. v. Comm'r*, 284 F.2d 737 (4th Cir. 1960) (44-year redemption notes not questioned as being unreasonable).
- <sup>20</sup> See, e.g., *Ruspyn Corp. v. Comm'r*, 18 T.C. 769, 779 (1952) (89-year term respected because substantially coextensive with term of lease on property owned by corporation), *acq.*, 1952-2 C.B. 3.
- <sup>21</sup> See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 448-49 (1971) ("[T]he power of purported creditors to vote on particular matters affecting their interests, such as mergers, sales or encumbrance of assets, or the like, is not inconsistent with indebtedness.").
- <sup>22</sup> See *Lots, Inc. v. Comm'r*, 49 T.C. 541, 549 (1968), *acq.*, 1968-2 C.B. 2.
- <sup>23</sup> *Plumb*, *supra* note 21, at 512-13 (and citations therein).
- <sup>24</sup> See, e.g., *Baker Commodities, Inc. v. Comm'r*, 48 T.C. 374, 396-97 (1967) (debt-to-equity ratio of almost 700-to-1 was not dispositive on issue of whether a shareholder advance was debt or equity because, given issuer's earnings history, there was reasonable expectation that cash flows of issuer would be sufficient to service debt), *aff'd*, 415 F.2d 519 (9th Cir. 1969); *Truschel v. Comm'r*, 29 T.C. 433, 439 (1957) (upholding characterization of instruments as debt for U.S. federal income tax purposes where a corporation had \$22 million in bonds and a stated capital of \$1,000), *acq.*, 1960-2 C.B. 7.
- <sup>25</sup> *Gilbert v. Comm'r*, 248 F.2d 399, 406 (2d Cir. 1957); *Am. Processing & Sales Co. v. United States*, 371 F.2d 842, 852 (Ct. Cl. 1967).
- <sup>26</sup> See *Curry v. United States*, 396 F.2d 630, 634 (5th Cir.); *cert. denied*, 393 U.S. 967 (1968).
- <sup>27</sup> See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 698 (3d Cir. 1968).