Article from:

Taxing Times

February 2010 – Volume 6, Issue 1

T3: *TAXING TIMES* TIDBITS

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *jtadney@davis-harman.com.*

Bryan W. Keene is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at *bwkeene@davis-harman.com.*

LIFE INSURANCE SURRENDER LOSS RULED DEDUCTIBLE

By John T. Adney and Bryan W. Keene

Until recently, the prevailing wisdom had been that a loss incurred on the surrender of a life insurance contract was not deductible for federal income tax purposes. That wisdom has now been supplemented by a further thought from the Internal Revenue Service ("IRS"): in some circumstances a surrender loss is indeed deductible.

In a private letter ruling issued on July 17, 2009, and released to the public on November 6— PLR 200945032—the IRS concluded that, subject to certain conditions, two affiliated banks were entitled to a deduction under section 165[1] for the loss each incurred upon the surrender of a group variable life insurance contract that each owned in connection with its trade or business. The bank-owned life insurance (or "BOLI") contracts had been purchased, according to the IRS's ruling letter, to offset the projected costs of the banks' future employee benefits. The losses arose because the market value of the assets supporting the BOLI contracts had deteriorated to amounts significantly below the premiums that the banks had paid for the contracts, and a so-called stable value feature associated with the funds did not protect the banks from the full amount of the losses. The conditions imposed by the ruling for allowance of the deduction related both to the ascertainment of the timing of the loss and the measurement of the loss.

The first condition that the IRS imposed on the allowance of the loss deduction was one of general application under the section 165 regulations, *i.e.,* that no portion of a loss for which there is a "reasonable prospect of recovery" on a claim for reimbursement of the loss is deductible until after the taxpayer ascertains "with reasonable certainty whether or not such reimbursement will be received."[2] The ruling recounts that the affiliated banks had filed a lawsuit against the insurer that had issued the contracts and the BOLI broker that had placed them with the banks, asserting that the insurer and broker had a duty to monitor and manage the investments supporting the contracts but failed to do so. This lawsuit constituted a pending claim for reimbursement of all or some of the losses incurred on the contracts' surrender, and thus the ruling held that the banks must wait to take the deduction for those portions of the losses as to which they had asserted a claim for reimbursement until after they have ascertained with reasonable certainty whether or not the pending claim will be successful. Presumably this condition requires each of the taxpayers to defer some or all of the otherwise allowable loss deduction until the outcome of the lawsuit (or its settlement) is reasonably clear.

The ruling's second condition addressed the calculation of the amount of the loss for which the section 165 deduction is allowed. According to the ruling, the amount of the loss with respect to each contract is determined by subtracting the contract's "tax basis" from the surrender proceeds, and for this purpose the surrender proceeds include any amounts received under a stable value feature and from any claim for reimbursement. Importantly, the ruling next concludes that the tax basis of each contract equals 1) the sum of the premiums paid for that contract and any "mortality credits" applied to it pursuant to an experience rating feature, minus 2) all cost of insurance ("COI") charges and net mortality and expense ("M&E") charges previously imposed under the contract. On the other hand, in the ruling the IRS did not require the tax basis of either contract to be reduced by fees charged for investment management and for the stable value feature, observing that those amounts would reduce only the surrender proceeds.

With regard to its determination of a contract's tax basis, the ruling acknowledged that section 72(e) generally governs the determination of taxable gain upon the surrender of a life insurance contract and does so without reduction for COI or other charges imposed under the contract.[3] The ruling reasoned, however, that section 165(a), not section 72(e), governs the determination of losses, and that section 165(b) provides that the basis for determining the amount of the loss is the adjusted basis provided in section 1011 for determining the loss from the sale or disposition of property. Citing to *Century Wood Preserving Co. v. Commissioner*[4] among other time-honored authorities requiring basis to be reduced for the cost of insurance protection in calculating the deductible amount of a loss, the ruling then concluded that the determination of each contract's adjusted basis under section 1011 requires a reduction for COI and M&E charges. While the ruling is not surprising in its requirement that COI charges must be subtracted from premiums paid in determining the adjusted basis for loss purposes—the old case law had so ruled, and the IRS had required the same subtraction in calculating the original contract owner's sale gain in Rev. Rul. 2009-13[5]—its extension of this treatment to M&E charges was new. The IRS offered no explanation for this extension. Likewise, no theory was offered to distinguish the fees charged for investment management and the stable value feature, by which the IRS did not require the contract's tax basis to be reduced.

Interestingly, the ruling also discusses the stable value feature under the BOLI contracts in some detail—the first ruling to do so. The ruling recites that the stable value feature had been amended three times in the past, with each amendment being accomplished by the insurer's creation of a new investment option under each contract together with the contract owner's reallocation of the contract values to the new investment option. The stable value feature was intended to protect the contract owner from some or all of any potential decline in the values of the underlying funds, which consisted of "bank eligible" investments that were managed with leverage and short selling to enhance the funds' returns. The ruling does not discuss or otherwise address the tax treatment of the stable value feature, including how that feature is treated under section 817(h).

In sum, PLR 200945032 stands for the proposition that a market-driven loss in a business-owned, variable life insurance contract is deductible by the contract owner-taxpayer. That conclusion had been hypothesized by a number of tax advisors, but until the ruling was issued, it was unclear that the IRS would agree with it. As generally required under section 165, of course, the deduction is premised on the ascertainment of the amount of the loss, particularly when a recovery on a reimbursement claim is possible. And the determination of the amount deductible must be made by adjusting basis to remove the expenditure for insurance protection, equated in the ruling to the COI and M&E charges.

END NOTES

1 Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
2 Treas. Reg. sec. 1.165-1(d)(2)(i).
3 *See* Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 (Situation 1).
4 69 F.2d 967 (3rd Cir. 1934).
5 *Supra* note 3. This aspect of the ruling was not without controversy. See Gelfond and Fujimoto, "Recent Guidance Involving the Taxation of Life Settlement transactions," 5 *TAXING TIMES* 27 (Sept. 2009).

IRS CHALLENGES ASSET DROP ASSUMPTION IN ACTUARIAL GUIDELINE 34

By Peter H. Winslow

The February 2010 *TAXING TIMES* supplement has an excellent comprehensive article by Edward Robbins and Richard Bush on the many actuarial and tax issues involved with Actuarial Guideline XLIII (AG 43). One tax issue the authors discuss is the potential tax impact of the asset drop assumption in the Standard Scenario. This matter merits further consideration because the issue the authors have raised also applies to prior tax years in the context of a similar asset drop assumption in Actuarial Guideline XXXIV (AG 34), which provides guidance on the computation of CARVM reserves for variable annuities with guaranteed minimum death benefits (GMDB). AG 34 has been superceded by AG 43, but presumably will continue to apply for tax purposes for variable annuities with GMDB issued prior to 2010.[1]

AG 34, like the Standard Scenario in AG 43, projects future guaranteed benefits by assuming an immediate drop in the value of the assets supporting the variable annuity contract, followed by a subsequent recovery at an assumed rate of return until the maturity of the contract. In a Notice of Deficiency[2] issued to CIGNA on March 12, 2009, the Internal Revenue Service (IRS) contended that AG 34 reserves do not qualify as life insurance reserves, at least to the extent they are attributable to the asset drop assumption, and, therefore, are not deductible as tax reserves. The IRS's inclusion of this issue in CIGNA's Notice of Deficiency was a surprise to the

CONTINUED ON **PAGE 36**

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

company because the issue had not been raised by IRS agents in the audit of CIGNA's tax returns. It also was a surprise to life insurance companies generally because the IRS National Office had been actively engaged in discussions with industry representatives on AG 43 tax matters and had not raised the asset drop assumption as a potential issue. In fact, Notice 2008-18[3] identified several tax issues of concern to the IRS for VACARVM (which became AG 43) and Principle-Based Reserves and did not mention this issue. The IRS also had issued a technical advice memorandum dealing with reserves computed using an asset drop assumption and never raised this as a problem.[4]

The IRS's legal theories behind its position in the CIGNA case are not well articulated in the Notice of Deficiency, but have been summarized in subsequent court filings. The IRS's argument seems to be that the portion of the AG 34 reserve attributable to the asset drop assumption is not held for future unaccrued claims under the contract, a requirement for life insurance reserve qualification under section 816(b) of the Internal Revenue Code. IRS contends that, because the assets in the variable annuity separate account are sufficient to fund the death benefit level if the annuitant were to die immediately, any reserves attributable to the asset drop assumption cannot be held for the current guaranteed death benefits. The IRS made this argument in a technical advice memorandum issued before the adoption of AG 34 and before the enactment of section 807(d) which requires tax reserves to be computed using CARVM as prescribed by the National Association of Insurance Commissioners (NAIC).[5] The IRS further contends that the reserve is being held for potential losses on assets owned by the company (*i.e.,* for an investment risk), relying on a 1967 revenue ruling.[6] The ruling states that a potential loss on assets is speculative and merely a solvency concern, and characterizes a reserve held for an investment risk as a contingency reserve, not a life insurance reserve.

In their article, Bush and Robbins set forth several reasons why the IRS would be wrong if it were to make similar arguments in an attempt to disallow a deduction for a portion of the Standard Scenario reserve under AG 43. The authors point out that: 1) the asset drop assumption is merely one of several assumptions used in the Standard Scenario to project separate account assets, and such a projection is necessary to estimate future benefits; 2) pre-1984 Act case law permitted a reserve deduction in analogous circumstances for risks inherent in guaranteed future settlement options that had not yet been elected; and 3) in any event, current section 807(d) requires the use of CARVM prescribed by the NAIC and does not authorize the IRS to second-guess the NAIC's judgment that an asset drop assumption is appropriate to compute the minimum reserve to be held for guaranteed benefits.

In the case of AG 34, there are additional important considerations that underscore the weakness of the position asserted by the IRS in the *CIGNA* case. One consideration is that the nonelective GMDB death benefits are guaranteed and can exceed the separate account assets. The Standard Valuation Law (SVL) is not very helpful in specifying how reserves should be computed for annuity contracts with GMDB, merely noting that reserves for benefits provided under a variable annuity contract must be appropriate in relation to the benefits and the pattern of premiums for the plan. The Model Variable Annuity Regulation is not much more help, simply providing that reserves for variable annuities must recognize the variable nature of the benefits provided and any mortality guarantees. One approach to compute the GMDB reserve for a variable annuity could have been to treat the guaranteed death benefit as a separate contract. How this approach would be implemented is unclear, however. For example, would Actuarial Guideline XXXVII principles for variable life contracts apply and, if so, how? Another approach could have been to compute a CRVM-type reserve for the net amount at risk (*i.e.,* the excess of the death benefit over the separate account assets). Such an approach necessarily would require the insurer to assume a particular set of rates of return such that net amounts at risk are projected. The asset drop assumption is just one option in selecting a rate-of-return assumption.

The NAIC declined to treat the death benefit as a separate contract and in Actuarial Guideline XXXIII (AG 33) clarified that an integrated reserve under CARVM should be computed taking into account all benefits under the contract, including death benefits. The problem faced by the NAIC was how to compute an integrated CARVM reserve. CARVM requires reserves equal to the greatest present value of the various guaranteed benefit options. Under this requirement, the assumptions made for guaranteed future death benefits, both in amount and in the probability of death occurring, are critical to determine whether they are part of the greatest present benefit value. The asset drop assumption in the integrated reserve in AG 34 was adopted to reflect the insurance risk inherent in the contract. It is inappropriate to view the asset drop assumption in AG 34 as resulting in a solvency reserve held for the risk that the insurer's assets will drop in value. Instead, the assumption serves to measure the future net amount at risk for the guaranteed death benefit which must be considered in the overall context of the integrated CARVM reserve. In arguing that the asset drop assumption is really a reserve for an investment risk, the IRS is missing the point that it is the assets in the general account that fund the GMDB, not the separate account assets. Even more fundamental, the IRS may be confused by the reference to "assets" in AG 34. Perhaps a more accurate way to refer to the rate-of-return assumptions in AG 34 would have been to describe an immediate drop in "account values" followed by subsequent account value increases.

The IRS cannot be insisting that traditional life insurance reserve CRVM principles derived from the SVL be used because CRVM does not apply to annuities. But, it is unclear from the CIGNA Notice of Deficiency and court filings how the IRS believes CARVM reserves should be recomputed and how any such recomputation would comply with section 807(d)'s mandate that the NAIC-prescribed method be used for tax reserves. The IRS not only has asserted that the asset drop assumption is improper, but also has argued that AG 34 cannot apply at all to contracts issued prior to the adoption of that actuarial guideline. Perhaps the IRS is contending that AG 33 should apply to contracts issued before the effective date of AG 34, but how or why the IRS believes a reserve computed under AG 33 must differ from an AG 34 reserve has not been explained. In fact, since the adoption of the Variable Life Insurance Model Regulation in 1974, an asset drop assumption has been standard practice in determining reserves for variable products. Moreover, AG 33 and AG 34 are consistent in principle and both require an assumption as to future rates of return on assets. So, the IRS must be arguing something like: "AG 33 should be applied in a manner that avoids an asset drop assumption." But, how this can be done while still reflecting the risks inherent in all future guaranteed death benefits in the CARVM integrated reserve required by AG 33 is a mystery. Expert witnesses undoubtedly will have some difficulty supporting the IRS's position in the *CIGNA* case because both the logic and the result of the IRS's position seem obscure.

END NOTES

1 Although AG 43 has retroactive statutory effect for contracts issued before its effective date, section 807(d) of the Internal Revenue Code requires the use of the NAIC's prescribed method in effect at the time the contract was issued, *i.e.,* AG 34 in the case of annuities with GMDB.

2 The IRS is required to issue a Notice of Deficiency proposing additional tax liability prior to assessment of tax to give the taxpayer an opportunity to file a petition in the U.S. Tax Court to challenge the IRS's position prior to payment. CIGNA exercised its right to file a Tax Court petition and its case is currently pending in that court. *CIGNA Corp. and Consolidated Subs. v. Commissioner*, No. 013645-09 (Tax Court petition filed June 4, 2009).

3 2008-5 I.R.B. 363.

4 TAM 200448046 (Aug. 30, 2004).

5 TAM 8111079 (Dec. 17, 1980).

6 Rev. Rul. 67-435, 1967-2 C.B. 232.

IRS FINDS RISK DISTRIBUTION IN TWO REINSURANCE ARRANGEMENTS

By Janel C. Frank and Gregory K. Oyler

Janel C. Frank is an associate with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *jfrank@scribnerhall.com.*

Gregory K. Oyler is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *goyler@scribnerhall.com.*

A recent Internal Revenue Service (IRS) revenue ruling confirms, for the first time in formal guidance, assumptions long-held by taxpayers about the proper analysis of risk distribution in the context of reinsurance. Revenue Ruling 2009-26 (2009 38 I.R.B. 366) analyzes risk shifting and risk distribution in the context of property casualty reinsurance, but its principles would apply equally to other types of arrangements, such as reinsurance of XXX life reserves, where a special purpose reinsurance company is used to assume risks from a single direct writer.

Revenue Ruling 2009-26 considers two fact patterns involving Insurance Company Y ("Insurance Co.") and Reinsurer Z and whether Reinsurer should be treated as an insurance company under I.R.C. § 831(c). In Situation 1, Insurance Co. entered into a 90 percent quota share reinsurance contract with the Reinsurer that covered 10,000 insurance policies issued by Insurance Co. in the commercial multiple peril line of business. This was the Reinsurer's only business during the year. The ruling found that the policies issued by Insurance Co. involved insurance risks, transferred those risks from 10,000 unrelated policyholders to Insurance Co., distributed those risks (in that a loss by one policyholder was not borne in substantial part by that policyholder's premiums), and were insurance in the commonly accepted sense. The ruling also found that the reinsurance contract between Insurance Co. and Reinsurer likewise transferred the risks to Reinsurer and constituted reinsurance in the commonly accepted sense. With respect to risk distribution, the ruling concluded that the reinsurance contract did nothing to disturb the distribution of the risks of the 10,000 policyholders that had been achieved by their policies with Insurance Co. Accordingly, the Reinsurer qualified as an insurance company for tax purposes. This analysis likewise suggests that reinsurance of the XXX life reserves of a single ceding company would meet the risk dis-

CONTINUED ON **PAGE 38**

tribution requirement for tax purposes even if that reinsurance constituted the entirety of the reinsurer's business.

In Situation 2 of the ruling, the facts were the same, except that the reinsurance contract with Insurance Co. covered the risks of only one policyholder (X, unrelated to Reinsurer), and Reinsurer also entered into reinsurance contracts with other insurance companies to assume additional policies in the same line of business. In this situation, although the risks of the single policyholder (X) assumed from Insurance Co. may not have been "distributed" when viewed in isolation, risk distribution was achieved by Reinsurer's assumption of similar risks of unrelated policyholders from other insurance companies, so that the risks of each original policyholder (including X) were distributed in that a loss by one policyholder was not borne in substantial part by that policyholder's premiums. Therefore, the ruling concluded, Reinsurer was treated as an insurance company under I.R.C. § 831(c) in Situation 2 as well. ◀

LIFE NOL CARRYBACK

By Craig L. Pichette, Charles J. Auer and Michael E. Bauer

On Nov. 6, 2009, President Obama signed H.R. 3548, *the Worker, Homeownership, and Business Assistance Act of 2009* (the Act) into law. Among other changes, Code sections 172 and 810 were amended to provide an extended carryback period for net operating losses and the loss from operations of a life insurance company, respectively.

Section 810 contains rules similar to the net operating loss (NOL) rules found in section 172, and is specifically applicable to the loss from operations of a life insurance company. Prior to amendment, the rules permitted such losses to be carried back three years and forward 15 years from the year in which the loss was incurred. The section 172 rules, in contrast, generally permit taxpayers to carry NOLs back two years and forward 20 years.

Section 13(c) of the Act adds new paragraph (b)(4), entitled "Carryback for 2008 or 2009 Losses," to section 810. New section 810(b)(4) provides an elective five-year carryback for the loss from operations of a life insurance company for tax years ending after Dec. 31, 2007, and beginning before Jan. 1, 2010 (*i.e.,* tax years 2008 and 2009).

A taxpayer may elect to use the entire five-year carryback period or may instead elect a four-year carryback. The election may only be made with respect to one tax year. An election must be made by the due date of the taxpayer's 2009 tax return, including extensions, and is irrevocable once made.

A special rule applies to losses carried back to the fifth tax year preceding the year in which the loss was incurred. The rule limits the amount of loss that may be carried back to such year to 50 percent of the taxpayer's life insurance company taxable income for such year. Life insurance company taxable income is computed without regard to the loss from operations for the loss year or any tax year thereafter. Appropriate adjustments are to be made in calculating the carryover to a future year from the fifth preceding year to take the 50 percent limitation into account.

The Act also suspends the 90 percent limitation on the use of any alternative minimum tax (AMT) NOL deduction attributable to carrybacks of the applicable NOL for which an extended carryback period is elected. Although not specifically mentioned, presumably this suspension would apply to AMT operations loss deductions as well.

The Act indicates that the manner in which the election must be made will be prescribed by the Secretary. Revenue Procedure 2009-52 was issued shortly after enactment of the Act and provides guidance on making the election. Under the Revenue Procedure, a corporate taxpayer (including a life insurance company) may make an election on their federal income tax return for the year of the applicable NOL by attaching a statement to their return. A taxpayer that has previously filed its income tax return for the taxable year of the NOL may attach an election to an amended income tax return, Form 1120X. The election must be made by the due date, including extensions, for the filing the taxpayer's 2009 tax return.

Corporate taxpayers may also make the election on Form 1139 by attaching a statement thereto. The due date for filing Form 1139 to make an election is extended to the due date of their 2009 return, including extensions. Taxpayers who previously filed a Form 1139 or an amended return must state on their election that the current election amends a previous application or claim. The election statement must indicate that they are making the election under section 810(b)(4), as provided for in Revenue Procedure 2009-52, the number of years that they wish to carry the loss back, and that they are not a Troubled Asset Relief Program (TARP) recipient nor an affiliate of a TARP recipient. In addition, taxpayers that have previously waived their carryback period and wish to avail themselves of the extended carryback must include a statement revoking their previous waiver.

In evaluating this election, a life insurance company should be cognizant of the impact that carrying back a loss could have on permitting the Internal Revenue Service to assert offsets with respect to taxable years for which the statute of limitations might otherwise have expired. Companies that make the election will also need to assess the impact on contingency reserves established for GAAP or statutory purposes.

The Act provides a special transitional rule with respect to any loss from operations of a life insurance company for tax years ending before the date of enactment. Under the transitional rule, any election made under section 810(b)(3) to waive the current law three-year carryback may be revoked before the due date, including extensions, of the taxpayer's 2009 tax return.

Lastly, taxpayers who are recipients under TARP prior to the Act's enactment, or receive such funds following its enactment, may not avail themselves of the five-year carryback if the federal government received an equity interest or warrants in the taxpayer in return for such funds. Freddie Mac and Fannie Mae are barred from applying the extended carryback. Taxpayers who at anytime in 2008 or 2009 were members of the same affiliated group as any of the aforementioned taxpayers are also ineligible for the extended carryback. The Act defines "affiliated group" by cross-reference to section 1504 but without regard to the exclusions of certain corporations (including life insurance companies) in section 1504(b).

The information contained in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

Craig L. Pichette is a partner in KPMG's Washington National Tax Practice and may be reached at *cpichette@kpmg.com.*

Charles J. Auer is a senior manager in KPMG's Washington National Tax Practice and may be reached at *cauer@kpmg.com.*

Michael E. Bauer is a senior associate in KPMG's Washington National Tax Practice and may be reached at *michaelbauer@kpmg.com.*