



Inside the IRS: An Interview with William J. Wilkins

By Christian DesRochers

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Last spring, President Obama nominated William J. Wilkins as Chief Counsel for the Internal Revenue Service and the Assistant General Counsel in the Department of Treasury. Both of these entities play a role in issuing rulings and notices that impact the work of insurance tax practitioners. With this in mind, the TAXING TIMES Editorial Board and the Taxation Section Council thought it would be important for the Taxation Section members to get to know William “Bill” Wilkins.

Prior to his nomination, Wilkins was a partner in the D.C. Tax Practice Group of Wilmer Cutler Pickering Hale and Dorr LLP, since 1988. He has a broad tax practice background that includes counseling nonprofit organizations, business entities and investment funds on tax compliance, business transactions and government investigations. Christian DesRochers, Taxation Section chair, caught up with the busy Wilkins who graciously agreed to be interviewed about the Office of Chief Counsel and his perceptions and expectations in his new role. Following is that interview.

DESROCHERS: Bill, congratulations on being named IRS Chief Counsel. It is not only an exciting opportunity, but a significant management challenge in transitioning from private practice to a government agency. The Service is a complex organization, including the Large & Mid-Size Business (LMSB) audit group, as well as Appeals and the National Office. Can you share with our readers your experiences in dealing with the Service from a private practice perspective?

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Taxing TIMES

FROM THE EDITOR WHO'S READING *TAXING TIMES*?

By Brian G. King

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It is quite common for Society of Actuary sections to produce newsletters. Thus, it came as no surprise when five years ago the new Taxation Section decided that it too would produce one. Five years and 19 issues later (including supplements), it is somewhat surprising how well received and broadly read *TAXING TIMES* has become.

From its inception, *TAXING TIMES* was well received by the Taxation Section members. The articles were timely and well written, and underwent a rigorous peer-review process. Readers gained education and insights on new and emerging tax matters impacting our industry. Given the fair amount of affiliate members present in the Taxation Section, our newsletter has had, from the very beginning, a wide readership, including actuaries as well as law, accounting, tax and other professionals in related fields.

However, recent references to *TAXING TIMES* by government personnel and in government publications suggest just how far its readership extends. This past May at the Federal Bar Association's 21st Annual Insurance Tax Seminar, several government people participating in session panels acknowledged that they in fact read *TAXING TIMES*. IRS Notice 2009-47, released on June 15, 2009, references SOA Taxation Section Task Force findings published in the May 2006 issue of *TAXING TIMES*. On Sept. 9, 2009, the Joint Committee on Taxation of the United States Congress released a description and analysis of President Obama's Fiscal Year 2010 budget proposals. This document included an explanation of a proposed modification to the Dividends Received Deduction for life insurance company separate accounts and cites a two-part article written by Susan J. Hotine and published in *TAXING TIMES*. In addition, in a recent SOA communications audit, *TAXING TIMES* was one of four SOA section newsletters cited as a premium product.

We should be proud! Our section newsletter has become a strong and influential voice for our section and our profession. It is providing timely and useful information to a broad audience on the tax issues impacting our industry. Through this valuable tool, we are making a difference.

I would like to personally thank all of you who have contributed articles in the past. Your hard work, expertise and willingness to write, often under tight timeframes, are the reason that we have such a successful publication. Thank you!

I would also like to encourage new authors to come forward and share their knowledge through publication in *TAXING TIMES*. With additional authors and new areas of tax expertise, our newsletter will benefit greatly. We have a quality publication to showcase our technical analysis and thoughts. All of our members have the opportunity to share in this work.

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

By Christian DesRochers

October 2009 marked the fifth anniversary of the establishment of the Taxation Section. The section has accomplished a great deal in our first five years, including this newsletter, which as Brian King's column notes, has been recognized as one of the premier sources of information on life insurance taxation and a valuable resource for learning about tax issues facing the life insurance industry today.

If I may add a personal note, I take a great deal of pride in the Taxation Section, as Ed Robbins and I were the sponsors of the Society Board resolution that was highly instrumental in getting the section started. Several other board members spoke up at that board meeting, offering support to what some people considered too narrow a practice area to warrant a section. However, despite the skepticism, we were given the go ahead to form the section. Currently, we have 813 members, including 65 affiliates.

Over the last five years, we have benefitted from the active participation of many people, including several people who are affiliate members of the section. Kory Olsen just finished a two-year term as section chair, and the section owes him a debt of gratitude for his hard work over his term. The Taxation Section Council itself has been helped not only by elected members, but "friends" of the council, who have provided invaluable advice. As a result, the Taxation Section has emerged as an important part of the taxation scene as it affects life insurance companies and products. That could not have been done without the participation of section members who have generously given of their time to section activities.

In the first issue of *TAXING TIMES*, Ed Robbins provided a vision for the section, which remains true today:

We need to nurture an environment where taxation is a major professional actuarial field and further an attractive career path for a young actuary. Knowledgeable tax actuaries who can work well with attorneys and accountants both inside and outside their organizations can enjoy rewarding careers. It is one of our primary mission objectives to encourage the development of strong leaders in the field.

While this remains a key challenge, I believe that through the efforts of the section, we have increased visibility of tax in the actuarial profession, and while we still have much work to do, we can see some of our younger members emerging into positions in their companies and firms, as well as gaining visibility in the industry.

The section has provided a forum through which we have added tax content to many SOA meetings and seminars. We have also developed both webinars and seminars, and provided support to basic education content. In the next year, we are planning to increase the number of Web-based programs, as we recognize that our members like Web delivery. As a part of the Society's efforts to update the section Web sites, we also have a redesigned Web site, which we hope can provide a useful resource to section members. In the fall of 2010, we will be sponsoring a Product Tax Seminar in Washington, D.C. We hope that we will be able to schedule and promote the Reserve and Company Tax Seminars, which we had to postpone this fall.

As a section, we are doing a good job producing *TAXING TIMES*, and providing content for both continuing and basic education, and we will work to maintain that effort. We would like to have a more active research program, which

we will also focus on in the upcoming year. This past year, the section sponsored a monograph on deferred tax authored through a committee headed by Ed Robbins. It is currently available on the section Web site. Next year, we hope to make some progress on the Tax Actuary Survey, which is an effort to better understand and document actuarial tax responsibilities within life insurance companies.

The role of sections within the Society of Actuaries is to connect with members on a grassroots level. We hope that the Taxation Section is seen by our members as fulfilling that role relative to tax matters. If there are issues of interest that are not being addressed, please let me know. Please also consider volunteering for section activities. Content for *TAXING TIMES* is always welcome, as well.

Overall, the Taxation Section has established a strong base on which to build for the future. I am honored to be the chair for this term, and look forward to an interesting year. ◀

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WILKINS: Thanks Chris. I devoted most of my private practice to transactions and tax counseling, although I would from time to time get involved in projects involving the Office of Chief Counsel. Some involved seeking private letter rulings and some involved possible published guidance. My limited involvement in tax litigation involved more brief writing than discussions with opposing counsel. I have also represented clients in the IRS Appeals process. Finally, my work in connection with the ABA Section of Taxation involved frequent interaction with Counsel in connection with comments on proposed regulations, CLE programs and general interaction on tax policy and administration.

DESROCHERS: Though it may be too soon to ask, now that you are “inside,” has your perception of the IRS and its work changed? How?

WILKINS: The people have certainly lived up to my expectations. They are highly skilled and dedicated professionals. The workplace is very enjoyable. I think people really like their jobs and feel they are doing important work. The nature of the work is also as expected—for me, a mixture of helping

the Commissioner and other senior executives, working on guidance and working on issues surrounding examinations, appeals and litigation. The unexpected things are relatively minor. It is the most hierarchical organization I have ever worked in. It has very clear lines of authority and every senior person has a team he or she can turn to in order to accomplish goals. This has been helpful in keeping more of my time free for legal and strategy work, and in providing support for that work. The other things are things I probably should have expected but didn’t think about: the emphasis on security of taxpayer information and IRS electronic equipment; the unique civil service and NTEU (National Treasury Employ

ees Union) structures around our employment practices; and the creative ways that the organization rewards and encourages outstanding performance.

DESROCHERS: Bill, with the perspective of your experience in private practice, what do you see as the similarities and/or differences between the role of a law firm and that of the Chief Counsel’s office?

WILKINS: The overarching similarity is found in dedication to client service and excellence. The differences are more numerous, but not as significant. As I mentioned, Chief Counsel and the IRS are hierarchical structures, with more similarity to a military organization or a large business than to a law firm. In a law firm, you would organize a project through ad hoc team building, sort of like a movie producer. In the IRS, you organize a project by identifying where it belongs and assigning responsibilities and goals to the part of the organization that takes the assignment. Another difference is that you are the in-house counsel, with a single client—and the client is the government. Another difference is that the written mission of our office includes the words, “Serve America’s taxpayers fairly and with integrity by providing correct and impartial interpretation of the internal revenue laws.” This is, intentionally, more tempered than the private lawyer’s mandate for zealous representation within the bounds of the law.

DESROCHERS: It sounds like management and policy are key elements of your responsibility, and in many respects, the Chief Counsel’s office is definitely a large firm. What are the challenges of being in charge of a “law firm” this large? Is one of your goals to leave your “mark” on the Office in some way?

WILKINS: Our office has been referred to as the largest tax law firm in the world. We have over 1,600 lawyers, divided about 60-40 between field offices and the national headquarters building. It is daunting to reflect on the intellectual firepower, size, diversity and influence of this organization. On the other hand, to do most things we need to cooperate with other parts of the government and with other parts of the IRS, and in many cases the cooperative processes require considerable patience and persistence.

As to the part about being in charge, it is a life changing experience to participate in decisions on both legal matters and management matters of the kind that come through this office. However, the organization would never run correctly if the Chief Counsel could not rely on managers, both in the national office and in the field, to make sure things go well and that strategic plans are developed and executed. Our team of managers is truly outstanding.

I really do not want to leave a mark in the sense that expression is usually used. For one thing, it implies my taking credit, and in this organization it takes many people to accomplish anything. I want to be alert to the events and opportunities that are going to be important during my time here—to exist in the moment, as they say. There is nothing wrong with doing a little planning ahead, but you can’t let it distract you from spotting

... One important question may be whether solvency regulation of the industry—which is part of the tax structure—will evolve to such an extent that another legislative update will be needed. ...

a potentially powerful set of events on the horizon and using your resources to guide them in a positive direction.

DESROCHERS: Bill, as an experienced tax lawyer, you have a reputation for being a good tax technician in that you have an appreciation of both the complexity of the Code provisions and their interaction. How do you see that influencing your new role as Chief Counsel?

WILKINS: Being more than 30 years into a tax career, and having practice experience with many different tax specialty areas, are proving to be extremely valuable in my new job. Federal tax law is a code-based practice, and having a comfort level with the statute and its structure is essential for the job. While you need to acknowledge the expertise of deeply specialized practitioners, you also need to have enough confidence in your own intellect to keep challenging the specialists if issues are unclear or if proposed answers don't make sense.

DESROCHERS: The readership of *TAXING TIMES* consists of actuaries and others, including attorneys and accountants with a keen interest in the issues related to the insurance tax arena. Do you have any experience with insurance tax in your prior life?

WILKINS: Most of my insurance experiences are from my 1981-1988 stint as a staffer on the Senate Finance Committee. I was the Finance Democrats' staff participant in the Stark-Moore discussions and processes, among other things. I did a modest amount of Washington policy representation for some insurance companies at the beginning of my career at Wilmer, Cutler & Pickering, but those experiences are pretty far in the past now.

DESROCHERS: We have recently passed the 25th anniversary of the 1984 Act, which was the ultimate result of the Stark-Moore efforts. In fact, our last issue of *TAXING TIMES* featured a retrospective piece on this legislation. From that retrospective, it became clear that the life insurance industry has undergone profound changes in the last 25 years, including the emergence of many new products as well as many challenges in risk management and capital structure. What are the most important issues that you see in administering the current tax law with respect to life insurance companies?

WILKINS: I do not want to get too specific here, as I am just getting back into these issues after being away for a long time. However, in the big picture, one important question may be whether solvency regulation of the industry—which is part

Department of the Treasury
2009-2010 Priority Guidance Plan

INSURANCE COMPANIES AND PRODUCTS

November 24, 2009

1. Final regulations on the exchange of property for an annuity contract. Proposed regulations were published on October 18, 2006.
2. Guidance on the tax treatment of a partial exchange or partial annuitization of an annuity contract.
3. Guidance on the classification of certain cell captive insurance arrangements. Previous guidance was published in Not. 2008-19.
4. Guidance on tax issues arising under §807 as a result of the adoption by the National Association of Insurance Commissioners (NAIC) of an Actuarial Guideline setting forth the Commissioners' Annuity Reserve Valuation Methodology for variable annuities (AG 43).
5. Revenue ruling regarding the tax-free exchange of life insurance contracts subject to §264(f).
6. Guidance clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6).
7. Guidance on the determination of the company's share and policyholders' share of the net investment income of a life insurance company under §812.
8. Guidance on treatment of age 100 maturity under §7702 based on comments to Notice 2009-47.
9. Guidance on annuity contracts with a long-term care insurance feature under §§72 and 7702B.
10. Revenue ruling providing guidance on reinsurance arrangements entered into with a single ceding company.

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Sometimes the world will not be convinced that we can sustain our position until some judges write some opinions—and similarly, sometimes it takes the same thing to convince us that we can lose.

of the tax structure—will evolve to such an extent that another legislative update will be needed to give us the ability to craft sensible tax rules.

In November, the Office of Tax Policy and IRS announced its 2009-2010 Priority Guidance Plan which include a number of projects directed at insurance companies and insurance products. A number of these initiative address topics that I'm sure readers of *TAXING TIMES* are well aware of, as they have been addressed in past issues of your newsletter. While I cannot comment on the specifics of items included in the business plan, there are a number

of insurance related projects that we will be focusing on in 2010 (See page 7).

DESROCHERS: Looking forward, as the new Chief Counsel for the IRS, what areas do you intend to focus on?

WILKINS: I think my areas of concentration will not be so much tax specialty areas as they will be areas of responsibility. I would say at this point that my expected areas will include helping the Commissioner execute important IRS priorities; attending to processes for published guidance, including helping resolve deadlocks or other uncertainties that may be slowing projects down; litigation strategy; and sustaining the office as a great place to practice tax law.

DESROCHERS: Following up on the last question, do you plan any reorganizations of the Chief Counsel's office? Any change in philosophy in litigation, rulings, etc.?

WILKINS: The short answer is no. I am pretty skeptical of reorganizations. However, I plan to be alert to situations where something could work better, and I will be open to making changes if the prospects for improvement are worth the problems that always come with organizational change. On guidance, I am encouraging people inside and outside the organization to identify areas where problems exist, or are threatened, because no one knows the official position of the IRS. In many of these areas, it will be worthwhile to make the effort to develop an official position. On litigation, my sense

is that the organization understands that sometimes litigation is essential to defending agency positions and to development of the law. Sometimes the world will not be convinced that we can sustain our position until some judges write some opinions—and similarly, sometimes it takes the same thing to convince us that we can lose.

DESROCHERS: Bill, thank you for taking time out of your busy schedule for this interview. I think it provides our readers with the opportunity to get to know you a little better and introduces you to the insurance tax community. I look forward to seeing your progress in your efforts as Chief Counsel. On behalf of the entire SOA Taxation Section, I wish you good luck in your new position. ◀

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CHANGE IN BASIS OF COMPUTING RESERVES—IS IT OR ISN'T IT?

By Peter H. Winslow and Lori J. Jones

High on the list of the most frequently asked questions by tax professionals working for life insurance companies is whether a change in reserving methodology or assumptions will be subject to the “10-year spread” requirements of section 807(f) of the Internal Revenue Code. Section 807(f) applies where there is a change in basis of computing certain reserves of a life insurance company. When applicable, it requires that the difference between the deductible insurance reserves listed in section 807(c) computed under the new method and the reserves computed under the old method as of the end of the year of the change be reflected ratably over 10 years. Usually the question is posed as, “Is the reserve change reflected all at once or is it spread over 10 years?” Understanding when the 10-year spread rule applies is important because it is a favorite topic for Internal Revenue Service (IRS) agents and is included as a disclosure item in the standard tax reserve questionnaire presented by the IRS to life insurance companies at the beginning of audits. And, it is a coordinated issue at IRS Appeals, which means that an individual Appeals Officer cannot settle a section 807(f) issue that has been raised in an IRS audit without first coordinating the proposed settlement with the Appeals Insurance Industry Specialist.¹

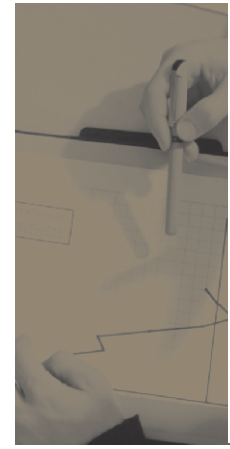
OVERVIEW OF GENERAL ACCOUNTING METHOD RULES VERSUS SECTION 807(f)

The starting place for any analysis of the tax consequences of a reserving change is to determine whether there would be a change in method of accounting for tax purposes in the absence of section 807(f). It is well-settled that section 807(f) is merely a special change-in-method-of-accounting rule for tax reserves and is intended to apply only when an accounting method change otherwise has occurred.² Although the application of section 807(f) is triggered by the same factors that give rise to a change in method of accounting, there are four differences in tax treatment. First and perhaps most important—unlike a change in method of accounting—IRS consent is not a prerequisite for recognizing a change in basis of computing reserves for tax purposes.³ A second difference is that an accounting method change is implemented in full in the

year of change with both opening and closing items for the taxable year computed on the new method. Under section 807(f), by contrast, only reserves for contracts issued in the year of change are determined under the new method and reserves for contracts issued prior to the year of change stay on the old method until the change for these contracts is implemented in the succeeding year when the opening and closing balances are computed using the new method. The third difference is the year of change in situations where the method from which the change is being made was erroneous. A taxpayer changing its method of accounting from an erroneous method cannot go back and correct the tax return for the first year in which the erroneous method was adopted unless the IRS agrees to the change on audit.⁴ Under section 807(f) and, specifically under Rev. Rul. 94-74, the taxpayer is permitted, but apparently not required, to correct an erroneous basis of computing reserves in the earliest year open under the statute of limitations. The fourth way accounting method changes differ from section 807(f) reserve changes is the treatment of the transition adjustment for the amount by which the opening balance of the reserve computed on the old basis is greater or less than the opening balance computed on the new basis. In the case of a change in method of accounting, the Code generally requires that the difference between the old and new method’s opening balances be reflected in taxable income all at once as a “481 adjustment,”⁵ although the IRS may provide for a spread of a net positive 481 adjustment as a condition of granting its consent to the change.⁶ In the case of section 807(f), the difference in opening reserves on the old and new methods for the taxable year succeeding the year of change is spread ratably over 10 years.

IS SECTION 807(f) APPLICABLE TO A NONLIFE INSURANCE COMPANY?

Before getting into specifics of when a reserve change is subject to section 807(f), it is useful to discuss two additional interrelated preliminary questions: what tax reserves are covered and what taxpayers are subject to section 807(f)? By its terms, section 807(f) applies to all tax reserve items for which life insurers are entitled to deductions on a reserve basis de-



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scribed in section 807(c). This includes not only life insurance reserves, but also reserves for other items including unearned premiums and unpaid losses, amounts held on deposit, advance premiums and premium stabilization reserves. Section 807(f) does not apply to reserve items other than those insurance reserves listed in section 807(c). For example, suppose a life insurance company deducted policyholder dividends on a reserve basis. This would be an erroneous accounting method for a life company because section 808(c) requires an accrual method for this item. To change to the correct accrual method, the life company would be required to obtain the consent of the IRS under section 446(e). The adverse 481 adjustment for the opening reserve balance would not be spread over 10 years under section 807(f), but would come into income all at once if the error is corrected by the IRS on audit or spread over four years if the life insurer identified the error on its own and alerted the IRS to the need for a change by filing a Form 3115, Application for Change in Accounting Method.⁷

The fact that section 807(c) is a Code provision that relates only to life insurance companies suggests that the 10-year spread rule only applies to life insurers. Other statutory provisions support this conclusion. For example, section 807(f) refers to part one of subchapter L which applies only to life insurers and section 807(f)(2) includes an acceleration rule for remaining section 807(f) adjustments if a company ceases to qualify as a life insurance company, with no reference to nonlife insurers. But, the IRS has long taken the position that the 10-year spread rule applies to changes in life insurance reserves by nonlife companies.⁸ This ruling position perhaps is in recognition that the tax policy of not requiring IRS permission to change reserve methodology and assumptions for life insurance reserves should apply equally to nonlife companies. Although when the IRS adopted this position under the 1959 Act it had dubious technical merit, it finds some statutory support under current law because life insurance reserves are now included in “losses incurred” of nonlife companies under section 832 by cross-reference to the life insurance company tax reserve provisions in section 807. This cross-reference arguably includes section 807(f). In any event, regardless of the technical merits, as a practical matter, section 807(f) invariably applies to life insurance reserves of nonlife companies. For reserve weakening, nonlife companies would prefer the 10-year spread. For reserve strengthening, IRS consent for a change would be required if section 807(f) did not apply. However, if a request for a change in method were submitted, the IRS likely would follow its ruling position and conclude that section 807(f) applies, thus imposing a 10-year spread of the reserve increases.

To summarize, section 807(f) applies: 1) only where a change in method of accounting otherwise would occur; 2) for life companies for all insurance reserves described in section 807(c); and 3) for nonlife companies only for life insurance reserves described in section 807(c)(1).

WHAT IS A CHANGE IN ACCOUNTING METHOD TO WHICH SECTION 807(f) APPLIES?

Once we have determined that we are dealing with a reserve item to which section 807(f) could potentially apply, we now are ready to apply the general principles to determine whether we have what otherwise would be a change in method of accounting. Guidance on whether a change in tax treatment of an item rises to the status of a change in method of accounting can be found in regulations under section 446. A change in method of accounting includes a change in the overall plan of accounting for gross income or deduction or a change in the treatment of any material item used in such overall plan.⁹ A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. However, a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. A change in method of accounting also does not include adjustments that do not involve the proper time for the inclusion of the item of income or the taking of a deduction. Further, a change in method of accounting does not include a change in treatment resulting from a change in underlying facts.¹⁰ In general, a change in basis of computing reserves occurs under these rules when there has been a systematic calculation of a reserve that has been changed, and both the old and new methods would yield the same total reserve amount at maturity of the contract. There are three general categories of adjustments to methods or assumptions that do not cause a change in method of accounting where reserve items are in question. These are: 1) correction of reserve mathematical or posting errors; 2) changes in the underlying facts; and 3) routine changes in estimates which are an integral part of the accounting method.

Correction of Error

Perhaps the most frequent issue that arises in dealing with section 807(f) is whether a reserve change is a correction of an error or a change from an erroneous method of accounting. The IRS takes the position that very few situations fall into the category of correction of an error. The IRS has stated that corrections of an error are limited to situations where there are pure mathematical mistakes, such as a defect in the computer

program for computing reserves.¹¹ For example, omitting certain contracts in computing reserves could be considered an error.¹²

It is a widely-held misconception that it is beneficial to classify reserve strengthening as a correction of an error so that a 10-year spread for the increase in reserves can be avoided and the entire increase deducted in the year of change. What frequently is overlooked is that typically there also is a corresponding reserve error in the opening reserves for the year—and this error in the opening reserve balance also must be corrected. When this is done, the difference between the opening reserves on the old basis and the new basis will be lost forever as a potential deduction if the change is classified as a correction of an error. It is a more favorable result either for the reserve error to be corrected in the first year the error was made (if it is still open under the statute of limitations) or for the change to be subject to section 807(f) with a 10-year spread equal to the amount of the strengthening. Of course, it would be beneficial for a decrease in reserves to be classified as a correction of an error, rather than reserve weakening subject to section 807(f), because there would be a permanent forgiveness of any opening balance of the reserve to the extent of the error. But, this result usually is too good to be true. Ordinarily, where both the opening and closing reserve balances for a year need to be corrected, a multi-year systematic error has been made—a situation that ordinarily should be characterized as a change from an erroneous method of accounting, not the mere correction of an error. As a general rule of thumb, it can be assumed that where there would be a positive or negative 10-year spread amount under section 807(f) as a result of a reserve change, the 10-year spread cannot be avoided by either the IRS or the taxpayer by asserting that a mere correction of an error is involved.

Change in Underlying Facts

An important exception to the application of section 807(f) is reserve increases (or decreases) that occur because the facts have changed. A change in method of accounting does not occur even if large one-year reserve adjustments are made if all that is happening is that the old accounting method is being applied to changes in circumstances. A good example where this has occurred is contract enhancements. When an insurance company adds benefits to the contract, the reserves must be increased to reflect the ad-

ditional benefits guaranteed in the contract. These reserve increases are not subject to section 807(f) because the basis of computing the reserve has not changed—the only change is in the underlying facts.¹³

One unresolved issue is whether a change in Annual Statement reporting of reserves is a change in facts. Under section 807(d), the amount of federally prescribed reserves in section 807(d) taken into account for deduction purposes is limited by the statutory reserves for the contract.¹⁴ What is the result where a company subject to the statutory reserves cap changes its statutory reserves for a contract, but the amount of the federally prescribed reserves for the contract does not change? Is this a change in basis of computing reserves subject to the 10-year spread? Legislative history suggests that a change to the net surrender value ordinarily will not be subject to section 807(f) presumably because the change is a mere change in facts relating to contract benefits.¹⁵ Many, probably most, tax practitioners believe that this legislative history applies by analogy to the change in statutory reserves cap situation.¹⁶ But, it is at least arguable that the computation of statutory reserves standing alone is an accounting method and a change in that method gives rise to the application of section 807(f). An interesting result would occur if section 807(f) were to apply in this situation. In such case, statutory reserves would have to stay on the old method for the year of change for contracts issued prior to the year of change with the result that the statutory reserves cap would apply to hypothetical statutory reserves that may not actually be held by the company.

This issue may become important in the context of Actuarial Guideline XLIII (AG 43). Now that AG 43 is effective, it applies for statutory purposes to all contracts issued on or after Jan. 1, 1981. However, tax reserves for contracts issued prior to the National Association of Insurance Commissioners' (NAIC) adoption of AG 43 are still subject to the NAIC-prescribed reserve method in effect on the date the contract was originally issued.¹⁷ When AG 43 results in a reduction of statutory reserves as compared to prior NAIC methodology, the statutory reserves cap could come into

What frequently is overlooked is that typically there also is a corresponding reserve error in the opening reserves for the year. ...

CONTINUED ON PAGE 12

play. The ACLI has taken the position that this should not be considered a change in basis of computing reserves subject to section 807(f).¹⁸

Change in Reserve Estimates

Another source of confusion in the application of section 807(f) involves situations when the basic accounting method itself contemplates periodic changes in assumptions and methodologies. The classic situation in the insurance context is changes in loss reserve estimates. In adopting the loss reserve accounting method, it is understood from the outset that estimates will be adjusted constantly to reflect new data as it becomes available and that assumptions—and even the reserving methods—may change to provide a more accurate updated estimate. These periodic adjustments to a reserve estimate do not result in a change in method of accounting. This conclusion is supported by Treas. Reg. § 1.446-1(e)(2)(ii)(b) which provides that a change in method of accounting does not include an adjustment with respect to a reserve for a bad debt.

In a 2001 technical advice memorandum,¹⁹ the IRS ruled that a change from a nonactuarial method to an actuarial method to estimate environmental claims was not a change in method of accounting.²⁰ Similarly, a 1992 private letter ruling involved a change in Annual Statement reporting by an insurance company dealing with the way it reported the value of foreclosed real estate from its mortgage activities.²¹ Prior to 1990, the company valued foreclosed real estate at the uncollected mortgage balance, despite the fact that NAIC rules required that the value be reduced to the extent that the estimated realizable value of the property was less than the uncollected mortgage balance. Beginning with its 1990 Annual Statement, the taxpayer modified its valuation procedures to take into account the actual fair market value of the foreclosed real estate (determined by appraisal), where that value was less than the mortgage balance. Application of this revised valuation approach for tax purposes affected the taxpayer's calculation of gains and losses on mortgage foreclosures. The IRS concluded that the use of a different method to determine the fair market value of an asset does not rise to the level of an accounting method because the estimation method only goes to the amount rather than the timing of income. Thus, the IRS ruled that the taxpayer's change in estimation method on its Annual Statement to determine the fair market value of foreclosed real estate did not constitute a change of accounting for tax purposes.

Case law also supports the conclusion that a change in estimate is not a change in accounting. In *Cincinnati, New Orleans & Texas Pacific Ry. Co. v. United States*,²² a railway company followed the method prescribed by the Interstate Commerce Commission (ICC) for expensing or capitalizing purchases of property. In accordance with the minimum capitalization rule of the ICC, the taxpayer changed from expensing items costing less than \$100 to expensing items costing under \$500. The Court of Claims held that, while the minimum capitalization rule is an accounting method, the change from \$100 to \$500 is not a change in that method. Also, in *Baltimore & Ohio R.R. Co. v. United States*,²³ the taxpayer changed from the use of one formula for computing fair market value of certain property to another valuation formula for computing fair market value. The court held that the taxpayer was entitled to change the valuation formula without seeking the IRS's consent, because the change was merely a change in the fair market value estimate.

The general rule that changes in loss reserve estimates does not result in a change in accounting method usually does not apply to changes in life insurance reserves because formulaic periodic updating of reserve estimates is not an integral part of the accounting method. This is not a hard-and-fast rule, however. For example, IBNR reserves for disability claims may qualify as life insurance reserves, and in some circumstances, may be computed using company experience. Where the company adopts a method for IBNR claims that incorporates periodic updates to its experience, a change in basis of computing reserves should not occur when the anticipated adjustments are made. This is a mere change in estimate similar to an adjustment to loss reserves and is not a change in basis of computing reserves. By contrast, a change in the interest rate assumption for the same reserves probably would be a change in basis of computing reserves subject to section 807(f).

This change-in-estimate exception to the application of section 807(f) and the change-in-method-of-accounting rules could become important when, and if, principle-based reserves (PBR) are adopted. An important aspect of PBR will be the unlocking of assumptions so that they are periodically updated to reflect the company's most recent experience. In Notice 2008-18,²⁴ the IRS questioned whether the unlocking could trigger the application of the 10-year spread rule of section 807(f) when reserve assumptions are changed. This would be the wrong answer, however. The unlocking in PBR is part of the accounting method itself and should not cause section 807(f) to come into play.

CONCLUSION

Resolution of virtually all reserve change issues can be resolved by correctly addressing the following basic questions outlined in this article:

1. Has a change in accounting occurred under general tax principles?

2. Is a section 807(c) reserve item or a life insurance reserve (for nonlife companies) involved?
3. Is a mere correction of an error, a change in facts or an anticipated periodic update in an estimate involved?

Section 807(f) will apply if the answers to Questions 1 and 2 are “yes” and the answer to Question 3 is “no.” ◀

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END NOTES

- ¹ Coordinated Issue Paper, *IRC Section 807 Basis Adjustment – Change in Basis v. Correction of Error*, Jan. 6, 1997.
- ² Rev. Rul. 94-74, 1994-2 C.B. 157, 159; *American General Life & Accident Insurance Co. v. U.S.*, 90-1 U.S.T.C. 50,010 (Mid. Dist. Tenn. 1989).
- ³ Under section 446(e), a taxpayer is not entitled to make a change in method of accounting without first obtaining the IRS' consent. This is true even if the method from which the change is made is erroneous or does not clearly reflect income. E.g., *Witte v. Comm.*, 513 F.2d 391, 75-1 U.S.T.C. 9477 (D.C. Cir. 1975).
- ⁴ *Diebold v. U.S.*, 16 Cl. Ct. 193, 63 A.F.T.R. 2d 89-599 (Cl. Ct. 1989). It takes two years of consistent treatment on tax returns to adopt a method of accounting for an erroneous method. See also Rev. Rul. 90-38, 1990-1 C.B. 57.
- ⁵ I.R.C. § 481; *Security Benefit Life Insurance Co. v. U.S.*, 517 F. Supp. 740 (D. Kan. 1980), *aff'd*, 726 F.2d 1491 (10th Cir. 1984).
- ⁶ Rev. Proc. 2002-19, 2002-1 C.B. 696. Under the revenue procedure, the section 481(a) adjustment period is four taxable years for a net positive adjustment and one taxable year for a net negative adjustment where IRS consent to the change in accounting has been properly requested by the taxpayer.
- ⁷ Rev. Proc. 2002-19.
- ⁸ Rev. Rul. 65-240, 1965-2 C.B. 236. See also TAM 200914022 (Dec. 2, 2008), where the IRS cited Rev. Rul. 65-240 favorably.
- ⁹ Treas. Reg. § 1.446-1(e)(2)(ii)(a).
- ¹⁰ Treas. Reg. § 1.446-1(e)(2)(ii)(b).
- ¹¹ Coordinated Issue Paper, Jan. 6, 1997.
- ¹² Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.
- ¹³ Rev. Rul. 69-444, 1969-2 C.B. 145 (where the IRS ruled that an increase in reserves because a life insurance company increased benefits is not attributable to a change of basis for computing reserves).
- ¹⁴ Statutory reserves are defined in section 807(f)(6) as the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term does not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserves is not permitted under section 811(c).
- ¹⁵ Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 604 (1984). On the other hand, the legislative history provides that changes in other reserve assumptions such as premium collection dates and claim payment dates cause differences subject to the 10-year spread.
- ¹⁶ EDWARD L. ROBBINS & RICHARD N. BUSH, U.S. TAX RESERVES FOR LIFE INSURERS 144-46 (Society of Actuaries 2006).
- ¹⁷ Under section 807(d)(3)(A)(iv) the tax reserve method prescribed by the NAIC which covers such contracts as of the date of issuance must be utilized.
- ¹⁸ ACLI letter dated October 24, 2008, to Chief Counsel Korb and Acting Assistant Secretary for Tax Policy Solomon. 2009 TNT 182-12, Doc. 2009-19684.
- ¹⁹ TAM 200115002 (Dec. 21, 2000).
- ²⁰ See also, in PLR 8406001 (Mar. 11, 1983), where the taxpayer had been using a flawed “paid-to-paid” method to compute its reserves for unpaid loss adjustment expenses and changed to a different paid-to-paid method and the IRS concluded there was no change in accounting method.
- ²¹ PLR 9222017 (Feb. 26, 1992).
- ²² 424 F.2d 563 (Ct. Cl. 1970).
- ²³ 603 F.2d 165 (Ct. Cl. 1979).
- ²⁴ Notice 2008-18, 2008-5 I.R.B. 363.



IRS RULES LONGEVITY CONTRACT IS ANNUITY UNDER SECTION 72

By Joseph F. McKeever, III and Michelle A. Garcia

In September 2009, the Internal Revenue Service (IRS) released a private letter ruling (PLR 200939018 (June 18, 2009)) addressing a contract in which the right to receive annuity payments and otherwise access a contract's cash value is contingent upon the annuitant living to a specified age. The ruling holds that the contract is an annuity contract for purposes of section 72 of the Internal Revenue Code (the "tax code"). While the conclusion of PLR 200939018 is not surprising to the authors, the release of the PLR should put an end to questions that were being asked in some quarters about the status of such contracts under the tax law. Before reviewing the specifics of the recent ruling, some background may be helpful.

The duration of the Deferral Period, subject to certain constraints, is chosen by the owner when the contract is issued and cannot be changed thereafter.

In the early to mid-1900s, a number of life insurance companies offered a form of deferred annuity contract that began payment of a life annuity if the annuitant was alive on a specified date, *e.g.*, his or her 75th birthday. These contracts provided no cash surrender value and if the annuitant died before the specified time, there was no death benefit. Such contracts provided pure longevity protection to individuals, *i.e.*, they were the annuity analog of term life insurance.

Under such a contract, the purchaser obviously assumes the risk of losing his or her premium in the event of a premature death. The lack of a cash value and death benefit, however, allows the insurer to provide significant amounts of retirement income cheaply in comparison to the purchase, for example, of an immediate annuity. Over time, these "pure" deferred annuities gradually all but disappeared from the retirement market place, perhaps because of the growth of the defined benefit plan system, followed by the focus in the last 20 to 30 years on asset accumulation rather than longevity protection.¹ In recent years, however, a few companies have once again begun to offer these types of contracts, often using the label of "longevity insurance" to describe the contracts.²

Historically, pure deferred annuity contracts have been viewed by the insurance industry as a type of annuity contract.³

As a result, there has been a presumption in the industry that the contracts were also annuities for federal tax purposes. Somewhat surprisingly, however, in the last couple of years some IRS officials raised the question of whether a contract that lacked a cash value should be treated as an annuity contract for tax purposes. The question arose both in the context of longevity insurance as well as with respect to other forms of "contingent" annuity contracts that have been introduced by a few insurers.⁴ While most observers did not give much credence to the idea that a contract's status as an annuity could be affected by whether or not it possessed a cash value,⁵ there was a paucity of guidance on the issue. As a result, PLR 200939018 provides a useful statement from the IRS confirming the treatment of longevity insurance as a form of annuity for tax purposes.

The Facts. The key feature of the contract considered in PLR 200939018 is that no cash value or death benefit is available for a period of time after issue, which is referred to in the ruling as the "Deferral Period." The duration of the Deferral Period, subject to certain constraints, is chosen by the owner when the contract is issued and cannot be changed thereafter. One such constraint is that the Deferral Period must always end on or before the "Maturity Date," on which date the annuity payments must commence if the contract has not been annuitized prior to such date.

The contract is issued after the payment of an initial premium and the owner may pay additional premiums thereafter subject to certain restrictions, including a prohibition on paying premiums for a specified period of time at the end of the Deferral Period. All premium payments, net of taxes and charges, are credited to a "contingent account value." The ruling—due to deletions presumably requested by the taxpayer—is vague on the specifics of how the contingent account value is determined, but it appears that certain amounts are credited to the contingent account value and certain charges are deducted from it. During the Deferral Period, the owner

cannot surrender the contract, take any withdrawals, or annuitize the contract. Further, no death benefit will be paid if the annuitant dies during the Deferral Period. If the annuitant dies or the contingent account value is reduced to zero during the Deferral Period, the contract will terminate without value.

If the annuitant is living and the contract is still in force at the end of the Deferral Period, the contingent account value will become the contract's cash value which thereafter functions like a conventional cash value, *i.e.*, the owner has the right to take partial withdrawals from the cash value, surrender the contract for its cash value, and apply the cash value to an annuity payment option. In addition, following the Deferral Period, the contract provides a death benefit equal to the cash value on the death of the annuitant. After the Deferral Period, the contract will terminate if the cash value is reduced to zero, the owner surrenders the contract, or the contract is annuitized, which must occur on or before the contract's Maturity Date.

Lastly, the contract is an annuity contract under the laws of the states in which it will be issued.

The IRS Analysis. The need for guidance on this type of product stems from the fact that neither the tax code nor its regulations define an annuity contract for tax purposes. As noted in the ruling, the tax code and regulations provide certain definitional rules and limitations on what types of products can be treated as an annuity, but there is no all encompassing definition of an "annuity contract." The ruling sets forth this background and then discusses Treasury regulation section 1.72-2(a)(1), which states that the contracts to which section 72 applies include those that are considered to be life insurance, endowment, and annuity contracts "*in accordance with the customary practice of life insurance companies.*"

Citing to a number of authorities, including law review articles, treatises, and a 1947 government report, the ruling observes that during the first half of the 20th century insurance companies issued deferred annuities that did not provide for any cash value or death benefit during the accumulation phase. Further, the IRS notes that nothing in the tax code, the income tax regulations or any other authority indicates that a cash value or death benefit is a predicate for annuity treatment under section 72 of the tax code. Thus, the IRS concludes that, "[i]n light of the fact that the contracts are substantially similar to typical deferred annuities," the lack of a cash value or death benefit during the Deferral Period is not inconsistent with the "customary practice" of life insurance companies.

The ruling also cites to a number of cases in which courts have described an annuity as a contract under which the issuer, in exchange for consideration, promises to pay a stated sum of money periodically over a term of years or for life. The IRS states in the ruling that periodic payments of interest under a contract, which do not liquidate principal, are distinguishable from periodic payments under an annuity, which liquidate a principal sum over the payment term. In addition, the ruling cites to IRS guidance which provides that if a contract lacks guaranteed annuity purchase rates it should not be treated as an annuity contract. The ruling concludes that, under each of these criteria, the contract should be treated as an annuity contract for federal tax purposes.

The Ruling's Reach. PLR 200939018 does not speak directly to the use of the contract in various types of qualified arrangements, such as IRAs, but the use of longevity contracts with IRAs presents some interesting challenges. There are two basic ways in which deferred annuity contracts are used with IRAs. In some cases, annuities are issued as a stand-alone "individual retirement annuity" under the rules of section 408(b) of the tax code. In other cases, an annuity is held as an investment of an IRA account under the rules of section 408(a) of the tax code. One obstacle to the use of longevity contracts in connection with IRAs is the need for the IRA to comply with the required minimum distribution (RMD) rules under section 401(a)(9). In general terms, the RMD rules require that beginning at age 70½ the account balance of an individual's IRA must be distributed over the individual's life or life expectancy.⁶ For purposes of determining the RMD from an IRA account for a year, the account balance of an IRA account is typically the fair market value of the account as of December 31 of the prior year.⁷

The RMD regulations applicable to IRA annuities provide that prior to the time the contract is "annuitized," the "entire interest" of the owner in the annuity contract is treated as the "account balance."⁸ The regulations explain that the "entire interest" under an annuity contract consists of 1) the dollar amount credited to the owner under the contract, plus 2) "the actuarial present value of any additional benefits" provided under the contract.⁹ As a result, if an individual wished to use a longevity contract with, *e.g.*, a maturity date of age 85, as an IRA annuity, he or she would need to take an annual RMD starting at age 70½ equal to the actuarial present value of the contract divided by the applicable factor from the Uniform Lifetime Table. However, since the contract has no cash value prior to age 85, a



In view of the RMD barriers to the use of longevity insurance in an IRA, legislation has been introduced in Congress to facilitate the use of longevity insurance in an IRA account or a qualified plan.

longevity contract has no cash value—the contingent obligations of the insurer under the contract would have value, which would be used to determine the amount of the RMD attributable to the annuity. To illustrate, assume Ann Jones is 72 and has an IRA account, the sole asset of which is a longevity contract which will commence a life annuity on Jones's 85th birthday. Also assume the contract has a fair market value of \$50,000 on Dec. 31, 2011. Under

prospective purchaser would not be able to pay RMDs prior to age 85. It is unclear whether such a contract could qualify as an IRA annuity under section 408(b), even if the individual possessed other IRA assets from which the RMD attributable to the IRA annuity could be taken.¹⁰

What about holding the longevity contract as an investment in an IRA account? In that circumstance, the fair market value of the contract would need to be taken into account along with the fair market value of any other assets in the account in computing RMDs.

In that regard— even though the

the RMD regulations, Jones would be required to take an RMD in 2012 of \$1,953.13, but the contract has no cash value from which to take the RMD.¹¹ The obvious way to address this problem is for Jones to hold liquid assets in the IRA account along with the longevity contract and to make the RMD payments from the liquid assets.

Such an approach, however, would require careful planning. First, the value of the longevity contract will increase as Jones approaches her 85th birthday, the date on which payments will begin under the contract.¹² Second, the RMD distribution period decreases as an individual ages,¹³ which, combined with the increase in the value of the longevity contract, means that the RMD attributable to the longevity contract will increase each year as the maturity date of the longevity contract approaches. This will require a corresponding increase in the amount of liquid assets available in the IRA to fund the RMD. Finally, the IRA will also need to hold sufficient assets to pay the annual RMD attributable to the value of the liquid assets because the RMD for the IRA account is based on the value of *all* of the assets in the account. In Jones's case, let's assume she has lived a healthy lifestyle and, on Dec. 31, 2024, the eve of the year in which she will turn 85, the fair market value of the contract is \$100,000. The RMD for 2024 attributable to the longevity contract will be \$6,756.76.¹⁴ However, at that time the IRA account will need to hold sufficient assets to pay not only the \$6,756.76, but the RMD on the asset generating the \$6,756.76, *i.e.*, the IRA will need to hold at least \$7,246.38.¹⁵

In view of the RMD barriers to the use of longevity insurance in an IRA, legislation has been introduced in Congress to facilitate the use of longevity insurance in an IRA account or a qualified plan. A bill introduced by Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL), for example, would disregard the value of longevity insurance held in a plan or an IRA account in applying the applicable RMD rules until the date that annuity payments begin, subject to certain limitations, *e.g.*, payments could not commence under the longevity contract later than 12 months following the date the employee attains age 85.¹⁶ The prospects for this legislation to be enacted in the next few years are uncertain, but given the societal needs for this type of product, the longer term prospects are better.

Conclusion. While the holding of PLR 200939018 that a pure deferred annuity is an annuity for federal tax purposes is not surprising, it is welcome, and it should lay to rest the

occasional questions that were being raised about whether such contracts are annuities for federal tax purposes. It remains to be seen, however, how these products will be

received in the marketplace, particularly for use with IRA assets. ◀

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END NOTES

- ¹ As early as 1929, MacLean noted that even though there is no benefit payable if the annuitant dies prior to the date the first annuity payment is due, "there is . . . no real forfeiture since the purchaser receives exactly what he pays for, but the popular distaste even for an apparent forfeiture renders such simple deferred annuities unattractive to most purchasers." MacLean, *LIFE INSURANCE* 62 (2d ed. 1929).
- ² Longevity contracts are also sometimes referred to as "contingent" annuities because the annuity payments are contingent upon the survival of the annuitant to a stated age.
- ³ These contracts are described in a number of texts and other sources as a form of annuity. See, e.g., S.S. Huebner, *LIFE INSURANCE* 59, 115 (1919); MacLean, *LIFE INSURANCE* 62 (2d ed. 1929); Robert Meisenholder, *Taxation of Annuity Contracts under Estate and Inheritance Taxes*, 39 Mich. L. Rev. 856, 860 (1941).
- ⁴ These other forms of "contingent" annuities, sometimes referred to as "stand alone withdrawal benefits," also lack a traditional cash value. These contracts promise to provide an annual payment based on the value of an account referenced by the contract for as long as the annuitant lives, even if the account value is reduced to zero, provided annual withdrawals are not made from the account in amounts exceeding a stated percentage (e.g., 5 percent) of the amounts deposited in the account. The assets in the account are owned not by the insurer but by the individual who purchases the contract. These forms of contracts raise a number of interesting income tax questions, including whether the contract is an annuity and whether the assets in the account are taxed the same as other assets owned independently of the contract (e.g., subject to capital gains treatment) or whether ownership of the contract might cause loss of capital gains treatment (e.g., under the straddle rules). As this edition of *TAXING TIMES* was being prepared for publication, the IRS released two private letter rulings addressing these contracts. See PLR 200949007 (July 30, 2009) and PLR 200949036 (July 30, 2009). These rulings will be discussed in the May 2010 issue of *TAXING TIMES*.
- ⁵ For example, an immediate annuity contract typically does not provide a cash value, but it is obviously an annuity contract for Federal income tax purposes. See, e.g., IRC § 72(u)(4).
- ⁶ IRC §§ 401(a)(9)(A)(ii) and 401(a)(9)(C); see also Treas. Reg. § 1.401(a)(9)-2. For most taxpayers, life expectancy is determined using the Uniform Lifetime Table set forth in Treas. Reg. § 1.401(a)(9)-9, Q&A-2.
- ⁷ Treas. Reg. § 1.401(a)(9)-5, Q&A-3; T.D. 9130, 2004-1 C.B. 1082 (June 14, 2004) (stating that the "IRS and Treasury believe that it is generally appropriate to reflect the value of additional benefits under an annuity contract, just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan."); Instructions for Forms 1099-R and 5498, at 15 (stating that the fair market value of the account on December 31 should be entered in Box 5 on Form 5498).
- ⁸ Treas. Reg. § 1.401(a)(9)-6, Q&A-12.
- ⁹ *Id.*; Joseph F. McKeever, III & Mark E. Griffin, *How to Value an "Additional" Annuity Benefit (Whatever That Is)*, Vol. 1, Issue 2, *TAXING TIMES*, September 2005, at 1.
- ¹⁰ Treas. Reg. § 1.408-8, Q&A-9, allows the annual RMDs for one IRA of an owner to be made from a different IRA of the owner.
- ¹¹ \$50,000 divided by 25.6 (the distribution period for a 72-year-old per the Uniform Lifetime Table in Treas. Reg. § 1.401(a)(9)-9, Q&A 2).
- ¹² As Ms. Jones ages and the time the longevity contract will begin payments approaches, the present value of the annuity benefits due under the longevity contract (and thus the contract's value) is steadily increasing.
- ¹³ The distribution period for a 70-year-old is 27.4 years, but that for an 85-year-old is only 14.8 years. Treas. Reg. § 1.401(a)(9)-9, Q&A 2).
- ¹⁴ \$100,000 divided by 14.8 (the distribution period for an 85-year-old. Treas. Reg. § 1.401(a)(9)-9, Q&A 2).
- ¹⁵ The amount of liquid assets required in the IRA, represented by the variable 'X,' can be solved by using the following equation: $X = (\$100,000 + X) \text{ divided by } 14.8$. In this example, $X = \$7,246.38$.
- ¹⁶ Retirement Security Needs Lifetime Pay Act of 2009, H.R. 2748, 111th Cong. § 3 (2009).

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GUIDANCE NEEDED TO CLARIFY ALLOWANCE OF ORDINARY LOSSES UNDER SECTION 165(g)(3) FOR WORTHLESS SECURITIES OF INSURANCE SUBSIDIARIES

By Maureen Nelson

The financial crisis of the recent past has prompted the director of the financial services industry portion of the Large and Mid-Size Business (“LMSB”) Division of the Internal Revenue Service (“Service”) to announce an increased focus during audit on the reporting by members of the financial services industry of losses attributable to bad debts or to worthless securities issued by subsidiaries.¹ The specific issues that might arise in an audit of claimed losses for worthless securities were not identified, but it is probably safe to assume that they would relate to whether the securities became worthless during the taxable year for which the losses were claimed² and, if so, whether the losses may be reported as ordinary losses under section 165(g)(3).³

Under section 165(g), losses from a subsidiary’s worthless securities must be reported as capital losses, unless less than 10 percent of the subsidiary’s total gross receipts have been from sources usually considered passive in nature, *i.e.*, royalties, rents, dividends, interest, annuities and capital gains (collectively, “passive source gross receipts”).⁴ In Rev. Rul. 88-65, however, the Treasury Department (“Treasury”) and the Service concluded that rental receipts of a subsidiary earned in connection with the operation of its active vehicle leasing business would not be counted as passive source gross receipts when determining whether the subsidiary had passive source gross receipts in excess of the maximum allowed under section 165(g)(3) for ordinary loss treatment.⁵ For several years thereafter, the Service agreed that under the published guidance the statute permitted parents of worthless financial service companies, such as thrifts and insurance companies, to exclude their subsidiaries’ passive source gross receipts earned in connection with the conduct of their banking or insurance businesses from being treated as passive source gross receipts in the determination of whether the subsidiaries had excessive passive source gross receipts.⁶

More recently, however, the Service has denied that the published guidance allows for excluding an insurer’s passive source gross receipts earned in connection with its conduct of an insurance business from the determination of whether

its passive source gross receipts have exceeded the maximum allowed for ordinary losses.⁷ Audit challenges to the character of the losses reported under section 165(g)(3) by members of the financial service industry are therefore likely to engender significant controversy because, as explained below, both taxpayers and revenue agents will be able to point to prior Service rulings, albeit unpublished, in support of the argument that Rev. Rul. 88-65’s interpretation of section 165(g)(3) does or does not support the allowance of ordinary losses. In light of these contradictory interpretations of Rev. Rul. 88-65 by the Service and the current audit attention of the LMSB Division on losses claimed under section 165(g) by parents of insolvent financial services company, it would be helpful if Treasury were to issue guidance that reiterates the interpretation of section 165(g)(3) set forth in Rev. Rul. 88-65 and clarifies that it applies to passive source gross receipts of insurance companies (and other similarly situated taxpayers) earned in connection with their active trades or business.

THE STATUTE

Section 165(g)(3) departs from the usual rule of section 165(g), which mandates capital loss treatment for a worthless security,⁸ by allowing a corporate taxpayer holding securities issued by an “affiliated corporation” that have become worthless during the year to report the losses as ordinary. A corporation whose securities have become worthless (the “issuer”) is “affiliated” with a corporate taxpayer only if both an “ownership” test and a “passive source gross receipts” test are satisfied. The ownership test, found in section 165(g)(3)(A), requires the taxpayer alone, or along with members of its consolidated group, to own at least 80 percent of the vote and value of the stock of the issuer; the gross receipts test, found in section 165(g)(3)(B), requires that “more than 90 percent of the aggregate of the corporation’s gross receipts for all tax years has been from sources other than royalties, rents . . . , dividends, interest . . . , annuities, and gains from sales or exchanges of stocks and securities.”⁹ The measure of gross receipts taken to satisfy the gross receipts test is the subsidiary’s aggregate total gross receipts for its entire period of existence and not its gross receipts for any particular tax year.¹⁰

If section 165(g)(3)(B) were to be interpreted literally, no corporation engaged in the insurance or banking or property rental business or software licensing business, for example, would ever qualify as an “affiliated corporation” inasmuch as the very nature of such a business requires the subsidiary to have passive source gross receipts well in excess of the maximum allowed under the language of section 165(g)(3)(B).¹¹ Yet in Rev. Rul. 88-65, Treasury and the Service ruled that a corporation with gross receipts consisting exclusively of passive source gross receipts nonetheless qualified as an “affiliated corporation,” with the result that its parent was allowed to report its losses from the issuer’s worthless securities as ordinary losses.

THE REVENUE RULING, ITS UNDERLYING GENERAL COUNSEL MEMORANDUM, AND THE LEGISLATIVE HISTORY

Revenue Ruling 88-65 involves the parent of a corporation in the vehicle leasing business. In connection with conducting that business, the corporation maintained the vehicles and paid all applicable taxes and insurance costs. In 1988, the issuing corporation’s shares became worthless. Despite the fact that the issuer had derived 100 percent of its gross receipts from rents, a type of passive source gross receipts identified in section 165(g)(3)(B), the ruling concludes that the issuer’s parent was entitled to report as ordinary the losses it incurred when the issuer’s securities became worthless.

Citing the legislative history underlying section 165(g)(3) (and its predecessor under the 1939 Code) to elucidate the purpose of the gross receipts test as a guide to interpreting section 165(g)(3)(B), Treasury and the Service observed that “Congress intended that an ordinary loss deduction for worthless securities be allowable only when the subsidiary is an operating company as opposed to an investment or holding company.”¹² Treasury and the Service therefore found it proper to look to other Code sections where Congress sought to make the same distinction and did so by measuring the amount of a taxpayer’s proceeds from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities, such as section 1244(c)(1)(C) and former section 1372(e)(5)(C). Guidance issued under those other Code sections provides that the term “rents” when used in the statute does not include rents received by a taxpayer who provides significant services in connection with earning the rents because the provision of such services reveals that the taxpayer is actively conducting a trade or business. As explained in Rev. Rul. 88-65, in order to further the congressional purpose in enacting section 165(g)(3), it is “appropriate to distinguish

between active and passive rental income in the same manner” as in regulations issued under section 1244 and former section 1372, and therefore “rents” received by a taxpayer providing significant services would not be treated as “rents” in determining the issuer’s satisfaction of the gross receipts test of section 165(g)(3)(B).

A more in-depth exploration of the relevant legislative history of section 165(g)(3) and the purpose of its particular definition of “affiliated corporation” is set forth in the general counsel memorandum (“GCM”) underlying Rev. Rul. 88-65.¹³ As explained in the GCM, prior to 1942, the Code required all loss due to the worthlessness of securities held as capital assets be treated as loss arising from the sale or exchange of a capital asset, *i.e.*, as capital loss. In the Revenue Act of 1942,¹⁴ Congress created the exception to the capital loss rule now found in section 165(g)(3) that, when applicable, eliminates capital asset treatment for such securities and therefore allows for ordinary loss when and if such securities become worthless. The Senate Finance Committee explained the purpose of this exception:

The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary.

Under present law, losses by a parent corporation on the stock or securities of a subsidiary corporation becoming worthless are treated as capital losses in the same manner as in the case of other stock or securities held by the taxpayer. The committee bill would permit such losses to be taken in full as ordinary losses by the parent if it owns directly 95 percent of each class of the stock of the subsidiary. Such parent and subsidiary may file consolidated returns and to this extent the corporate entity is ignored. Thus the losses of one may be offset against the income of the other. It is deemed desirable and equitable, therefore, to allow the parent corporation to take in full the losses attributable to the complete worthlessness of the investment in the subsidiary.¹⁵

The Service explains in the GCM that Congress permitted ordinary loss treatment when the taxpayer and the issuer were closely enough related to file consolidated returns, even if they did not in fact so file (the ownership test),¹⁶ to ensure

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that if and when the securities of the subsidiary become worthless the loss would be regarded as a business loss of the parent corporation rather than as a loss on an investment.¹⁷ “In the case of consolidated return treatment, the losses of one may be offset against the income of the other. In the case where the securities of the subsidiary company becomes [*sic*] worthless, following the same concept, the loss, in effect, is regarded as a loss of part of the business of the parent corporation rather than as a loss on an investment.”¹⁸ And in keeping with this notion of allowing ordinary loss for the operation of a business but not for an investment, Congress included the gross receipts test “to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company.”¹⁹ As the GCM notes, the statute’s prohibition on excessive passive source income effects the “distinction between active and passive business operations” discussed in its legislative history.²⁰

THE COURT CASE

Although neither the revenue ruling nor the general counsel memorandum mentions it, years earlier the Service had convinced two courts that the statute’s prohibition on excessive passive source gross receipts should be interpreted literally. Under such an interpretation, the taxpayer, a retail store that owned a bank that provided banking services to the store’s customers, was not entitled to report ordinary losses when the bank’s securities became worthless because the bank had interest receipts

that exceeded the maximum allowed under the predecessor to section 165(g)(3)(B). The taxpayer pointed to the active business operations of the bank subsidiary and cited the same legislative history relied upon by Treasury and the Service in Rev. Rul. 88-65 in support of its argument that it should be allowed ordinary loss treatment. In rejecting the taxpayer’s request that it reject an “over-literal reading” of the statute and instead adopt an alternative reading consistent with the intent of Congress to permit ordinary losses when the issuing sub-

In each instance, the conclusion the parent was entitled to report ordinary loss was based on the determination that the passive source gross receipts of the subsidiary were earned as part of the operation of its active trade or business. ...

sidaries were active operating companies, the Court of Appeals for the Second Circuit warned:

[T]he proposed alternative reading applying to “all operating companies” would open the door to insurance companies, finance companies, real estate operating companies, etc., without suggestion of any workable limitation. Congress has enunciated a clear and simple rule which ... is not to be set aside.²¹

THE UNPUBLISHED RULINGS

With the publication of Rev. Rul. 88-65, Treasury and the Service opened the door to ordinary loss claims with their rejection of the literal interpretation of the gross receipts test of section 165(g)(3)(B) approved by the courts in *Adam, Meldrum* and their adoption of an analytical approach to the interpretation of section 165(g)(3)(B), necessary to effect congressional intent to permit ordinary losses when the worthless securities were issued by an active operating subsidiary. But did Treasury intend to open the door to parents of some types of active businesses that necessarily earn significant amounts of passive source gross receipts in the conduct of their businesses, only to deny entry to parents of insurance companies?²² Nothing in Rev. Rul. 88-65 or in the legislative history of section 165(g)(3) justifies such a narrow opening and, indeed, at first the Service acknowledged the applicability of the analytical approach of Rev. Rul. 88-65 to all active businesses generating significant amounts of passive source gross receipts in the conduct of their trades or businesses. Under the guidance of Rev. Rul. 88-65, the Service issued taxpayer-favorable rulings to the parents of insolvent insurance companies,²³ finance companies²⁴ and rental businesses,²⁵ all with excessive passive source gross receipts. In each instance, the conclusion the parent was entitled to report ordinary loss was based on the determination that the passive source gross receipts of the subsidiary were earned as part of the operation of its active trade or business and therefore should not be treated as passive source gross receipts for purposes of the gross receipts test of section 165(g)(3)(B).

For example, in PLR 9218038 (Jan. 29, 1992), the Service ruled that the nonbank parent of a thrift savings bank could report its losses on the thrift’s worthless stock as ordinary losses, despite the subsidiary’s failure to satisfy the literal language of section 165(g)(3)(B).²⁶ In response to the taxpayer’s request that the Service determine that the “interest” income referred to in section 165(g)(3)(B) did not include

interest “actively earned” by the subsidiary, the Service acknowledged the favorable precedent of *Adam, Meldrum* that would permit it to reject this interpretation. The Service noted, however, that such interest was similar to the types of passive source income included in the Code sections identified in Rev. Rul. 88-65, viz., sections 1244(c)(1) and 1372(e)(5)(C), and under those Code sections “a distinction is made between amounts received from the active conduct of a business and passive or investment income.” In addition, noted the Service, section 543 includes in personal holding company income the same types of passive source gross receipts identified in section 165(g)(3)(B), but section 542 excludes from the definition of a personal holding company a lending or finance business, even though such businesses earn significant amounts of interest income. Finally, the Service also identified section 469, concerning the limitations on passive activity losses, as another place in the Code where interest income earned in the ordinary course of a trade or business should be distinguished from interest on investments. The Service concluded that, as it was for rents in Rev. Rul. 88-65, the distinction between active and passive income should be applied to interest earned as part of the active conduct of a trade or business for purposes of the gross receipts test of section 165(g)(3)(B).²⁷

In field service advice issued two years later,²⁸ the Service noted that “[i]nsurance companies are required to accumulate and invest reserves to pay out on losses of the insured” and by doing so generate large amounts of passive source gross receipts. Nonetheless, the Service ruled that the parent of an insurance company, the shares of which had become worthless, could report the losses as ordinary. In extending the application of Rev. Rul. 88-65 to parents of insurance companies, the Service stated:

Despite *Adam, Meldrum & Anderson*, we will no longer follow a literal interpretation test of section 165(g)(3). Instead, we will look to whether the income was “active” or “passive.” In Rev. Rul. 88-65, the income was clearly from rents; however, the business was being actively managed. We believe that the distinction between active and passive income should be applied to other types of income. For example, a savings bank would be considered an actively managed business, notwithstanding the fact that its income was “interest” and a loss arising from the worthlessness of its securities would be an ordinary one to its parent. See PLR



9218038 (1/29/92). Accordingly, we would restrict the application of section 165(g)(3) to those situations in which the activities of the subsidiary are [not] (*sic*) passive in nature. In your case, an insurance business is an actively managed business and its income from interest and dividends are part of that business.

The Service next “opened the door” to the parent of another insolvent insurance company in a technical advice memorandum issued shortly after the field service advice.²⁹ In this ruling, the taxpayer acquired an insurance company in 1987 that shortly after acquisition experienced significant underwriting losses. During the period 1982-1990, 43 percent of the insurance company’s gross receipts were passive source gross receipts. By 1990, the insurance company’s reserve liabilities exceeded its assets and it was declared insolvent and placed in rehabilitation by the state insurance regulator. The taxpayer reported its loss from the worthless securities as ordinary loss and this treatment was challenged during audit. In the technical advice memorandum issued to the audit team, the Service agreed that the insurance subsidiary would not satisfy the gross receipts test of section 165(g)(3)(B) were the statute to be interpreted literally. While noting that the court in *Adam, Meldrum* had refused to consider the legislative history of section 165(g)(3) in denying ordinary loss treatment, the Service explained that “in contrast to this literal approach in defining the scope of section 165(g)(3) of the Code, Rev. Rul. 88-65 [citation omitted] employs a more analytical ap-

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proach ... and relies for its rationale, in part, on the congressional purpose underlying section 165(g)(3).”

In TAM 9538005, the Service acknowledged that the subsidiary described in Rev. Rul. 88-65 was a vehicle rental company, not an insurance company. The Service noted that in their need to earn passive income, insurance companies are similar to banks, although they do not have the special rules that banks have under Treas. reg. §§ 1.165-5(h) and 1.582-1, which provide that if a bank subsidiary of a bank satisfies the ownership test, its securities will not be treated as capital assets in the hands of its bank parent. But this lack of a special rule for insurance companies did not deter the Service from concluding that the insurance subsidiary’s passive source income should not be treated as passive source gross receipts in ascertaining the subsidiary’s satisfaction of the gross receipts test. Just as in other situations—such as in the passive activity loss rules of section 469 and the personal holding company rules of section 542— where the receipt of excessive income from passive sources mandates or excludes specific tax treatment, the tax law treats the receipt of interest by insurance companies the same as the receipt of interest by banks because both earn interest as a necessary part of the active conduct of their businesses. Indeed, noted the Service, in the personal holding company legislation, “Congress sought to place insurance companies on the same field as banks, both of ‘whose active businesses involve the investment of funds and the earning of interest and dividends.’”³⁰

In concluding that the insolvent insurance company subsidiary should be treated as an “affiliated corporation” of the taxpayer, the Service in TAM 9538005 again referred to the legislative history underlying section 165(g)(3) and its predecessor as demonstrating congressional intent to permit ordinary loss when the subsidiary is an operating company and denying it when the subsidiary is an investment or holding company. The receipt of large amounts of income from passive sources, explained the Service, does not contradict the conclusion that an insurance company is an active business; rather, earning investment-type income is an integral part of its provision of insurance to customers.³¹ Thus, excluding the interest and other passive source gross receipts of an insurance company from the meaning of royalties, rents, interest, etc, as those terms are used in section 165(g)(3)(B), is appropriate.

The similar treatment of interest from banks and insurance companies in the context of passive and active income

has been viewed as justified by practical reality. As with banks, investments are an integral part of an insurance company’s business and are a principal source of its income. [Citation omitted.] Although life insurance companies are taxed differently than other types of insurance companies, life insurance companies maintain reserves that are expected to earn investment income. The investments that earn this income are an essential component of insurance companies’ businesses. In addition, the activity necessary to earn interest in the situations of both banks and insurance companies is similar. Both involve similar types and amounts of effort to attract borrowers/insurers, to process their applications and premiums, to administer, account for, and report appropriate information, and actively to oversee and supervise invested funds.

In this case, Insurance Company was an active insurance company, which actively sold credit life, accident and health insurance policies and earned significant premiums in connection therewith, which it invested as an integral part of its business and source of income. [Footnote omitted.] This is not the type of passive holding company that was intended to be excluded from the special ordinary loss treatment of section 165(g)(3) of the Code.³²

Although this ruling is well-reasoned, entirely consistent with prior unpublished rulings, and amply supported by the analysis and rationale of Rev. Rul. 88-65, the Service signaled its desire to follow a different path two years later when it announced, in response to a letter ruling request, its withdrawal and reconsideration of TAM 9538005.³³ The Service revoked the 1995 TAM with the issuance of TAM 9817002,³⁴ in which it offered a more narrow interpretation of the scope of Rev. Rul. 88-65 than prior unpublished rulings, articulated a new explanation for the purpose of section 165(g)(3), and adopted a test different than that used in Rev. Rul. 88-65 for ascertaining when certain passive source gross receipts should not be included in the passive source gross receipts described in section 165(g)(3)(B).

At first, the “law and analysis” portion of TAM 9817002 reads much like those of the rulings described above, with a summary of the statute, a short discussion of its legislative history, and an explanation of the “analytical approach” of Rev. Rul. 88-65. In the 1998 TAM, however, the Service offers a new and slightly different congressional purpose for the ordinary loss rule found in section 165(g)(3) and suggests it

was enacted to permit the parent to obtain the effect of filing a consolidated return with its subsidiary and thereby report directly the ordinary (or capital) losses the subsidiary would have recognized and contributed to consolidated taxable income had the subsidiary sold the assets producing the passive source gross receipts.

The legislative history further indicates that its purpose was to provide the parent corporation with an ordinary loss in order to correspond more closely to the treatment allowed if the parent and subsidiary were able to ignore the separate corporate entities by filing consolidated returns. It also provides that, in such circumstances, the losses of one corporation may be offset against the income of the other, thus providing an indication that those losses should be treated as ordinary losses. Therefore, it is appropriate to treat the claimed loss arising from the worthlessness of the subsidiary stock in a manner consistent with the treatment the parent would have been afforded if the parent disposed of the underlying assets of the subsidiary directly.³⁵

This recasting of the congressional purpose for section 165(g)(3) leads the Service in effect to adopt a new standard for when passive source gross receipts will not be treated as royalties, rents, interest, etc., under section 165(g)(3)(B). Rather than employing the test of Rev. Rul. 88-65, *i.e.*, ascertaining whether the subsidiary was actively engaged in a trade or business, the losses from which resulted in its securities becoming worthless, the Service in TAM 9817002 employs a look-through test—it requires the parent to adopt as the character of its worthless securities the character of losses the subsidiary would have reported had it engaged in a hypothetical sale of the assets generating the passive source gross receipts. (The ruling also suggests the Service would impose as a prerequisite to the allowance of ordinary losses under this new look-through approach that the hypothetical sale of the assets generating the passive source income generate net loss.)

There is no indication in the record that the assets generating the interest, dividends and capital gains of Insurance Company did not constitute capital assets in the hands of Insurance Company. Treating income from these assets as not being from interest, dividends and capital gains within the meaning of section 165(g)(3)(B) would be inappropriate when the disposition of the underlying assets generating that income would give rise to capital

rather than ordinary treatment. To do so would have the unacceptable effect of converting what would have been a capital loss to Insurance Company into an ordinary loss to taxpayer.³⁶

Because the assets producing passive source gross receipts were capital assets, the insurance company described in TAM 9817002 would have reported any gain or loss on their sale as capital gains or losses. Accordingly, ordinary loss on the worthless securities was denied to the parent.

Nothing in the statute, its legislative history or Rev. Rul. 88-65 supports this “hypothetical sale, look-through” interpretation of section 165(g)(3), however. And nothing in either the 1995 TAM or the 1998 TAM indicates that the insurance company had built-in losses in its investment portfolio. The underlying facts, set forth in greater detail in TAM 9538005, do indicate, however, that the subsidiary’s losses were due to its unfavorable underwriting activities. Had the results of this underwriting activity been reported directly by the parent, it would have produced ordinary loss to the parent and had this book of business been reinsured, it would have produced a net deduction, due to the likely negative ceding commission reinsuring such a book of business would require.³⁷ This is exactly the situation section 165(g)(3) was enacted to address.

Contrary to the description of congressional purpose in enacting section 165(g)(3) set forth in TAM 9817002, the legislative history of section 165(g)(3) demonstrates (and the GCM underlying Rev. Rul. 88-65 explains) that Congress enacted the ordinary loss rule of section 165(g)(3) because when two companies are closely enough related to file consolidated returns (even when they do not), it is appropriate to treat them as in effect consisting of one operating business. When the subsidiary is merely a passive investment company, its losses are investment losses and the parent’s costs of capitalizing the subsidiary should also be treated as investment losses.

When the subsidiary’s losses from the active conduct of a trade or business render its securities worthless, the parent’s

There is no indication in the record that the assets generating the interest, dividends and capital gains of Insurance Company did not constitute capital assets in the hands of Insurance Company.

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costs of capitalizing the insolvent subsidiary should be treated as the parent's own losses from a trade or business rather than as investment losses of the parent from the sale or exchange of its subsidiary's securities, a result not otherwise provided for under the Code, even for consolidated taxpayers. To distinguish between passive investment subsidiaries and active operating subsidiaries, Congress incorporated into section 165(g)(3) the gross receipts test of section 165(g)(3)(B). But congressional purpose in enacting the predecessor of section 165(g)(3) is only given effect if the gross receipts test is construed as excluding rents, royalties, interest, dividends and capital gains earned as part of the active conduct of a trade or business. This is the foundation on which Rev. Rul. 88-65 is based, not that the income-generating assets themselves are not capital assets.³⁸

CONCLUSION

Other recent unpublished guidance applying section 165(g)(3) that could be read as contradicting or being inconsistent with prior unpublished guidance suggests it is time for additional published guidance. For example, in rejecting a taxpayer's argument that the fact that its worthless subsidiary had zero gross receipts and therefore did not have excessive gross receipts from passive sources, the Service has said that "where, as here, Congress has imposed a test for eligibility for a particular tax benefit that 'more than 90 percent of the aggregate of gross receipts...' must come from sources other than those enumerated, it has also imposed a requirement that there be gross receipts."³⁹ But in TAM 200914021 (April 3, 2009), the Service concluded that a corporation that became worthless in its first year of existence and never had any gross receipts nonetheless satisfied the gross receipts test of section 165(g)(3)(B). While it is true that in the earlier ruling, the worthless subsidiary was described as a holding company, whereas in the later ruling, the subsidiary was described as an operating company, the Service chose to base its disregard of the subsidiary's failure to satisfy the literal

requirements of the statute on congressional intent as reflected in the legislative history of section 165(g)(3):

We think that the legislative history supports a broader reading of the operating company exception to capital loss treatment.

The gross receipts test was apparently designed to determine whether a subsidiary is an operating company (for which an ordinary loss is allowed) or a holding or investment company (for which an ordinary loss is not allowed). ... We conclude that the legislative history supports Taxpayer's argument that Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company.

The new focus of LMSB on financial institutions claiming ordinary losses under section 165(g)(3) for worthless securities issued by subsidiaries and the current state of the Service's rulings, which seem to permit owners of rental companies, thrift savings banks and software licensing companies to disregard the passive source gross receipts of their subsidiaries when the subsidiaries were active operating companies but deny such treatment to owners of active insurance companies, presents a situation ripe for controversy and best resolved by published guidance. New guidance from Treasury should be consistent with Rev. Rul. 88-65 and treat passive source gross receipts of an insurance company earned as part of its active insurance business as not constituting royalties, rents, interest, dividends or capital gains as described in section 165(g)(3)(B). ◀

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END NOTES

- ¹ See "IRS Official Previews Exam Issues Raised by Financial Crisis," *Tax Notes Today*, May 11, 2009 ("An IRS official on May 8 flagged areas in which the Service expects to see an increase in issues raised during examinations of financial services companies as a result of the economic crisis. ... Walter Harris, director of the financial services industry at the IRS Large and Midsize Business Division, spoke at the Banking and Savings Institutions session of the American Bar Association Section of Taxation meeting in Washington. He said the IRS is watching developments and anticipating what issues will come up in exams conducted against the background of the economic downturn and resulting moves by financial institutions. The IRS is gearing up to see more issues involving treatment of bad debts under section 166 and worthless stock under section 165(g), Harris said.") This article concerns worthless stock losses under section 165(g).
- ² A discussion of the legal standard for ascertaining when securities are considered to have become worthless and a loss may be recognized by the owner of such securities is beyond the scope of this article. See, however, Treas. reg. § 1.165-1(b) and (d) and Treas. reg. § 1.165-5(i).
- ³ All section references are to the Internal Revenue Code ("Code") of 1986, as amended, unless otherwise specifically stated.
- ⁴ See section 165(g)(3).
- ⁵ See Rev. Rul. 88-65, 1988-2 C.B. 32.
- ⁶ See PLR 9218038 (Jan. 29, 1992), FSA 1159 (Jan. 25, 1994), and TAM 9538005 (Sept. 22, 1995), discussed *infra*.
- ⁷ See TAM 9817002 (Jan. 5, 1998), discussed *infra*.

END NOTES (CONTINUED)

- ⁸ When a security that is a capital asset becomes worthless, the resulting loss must be treated as arising from the sale or exchange of the security. Section 165(g)(1).
- ⁹ Excluded from "rents" are rents derived from properties leased to employees in the ordinary course of business and excluded from "interest" is interest received on the deferred purchase price of assets sold. See section 165(g)(3)(B).
- ¹⁰ Rev. Rul. 75-186, 1975-1 C.B. 72. The regulation under section 165(g)(3)(B), which merely repeats the statutory language describing the gross receipts test, adds nothing to the understanding of the application of the ordinary loss rule of section 165(g)(3). See Treas. reg. § 1.165-5(d)(2)(iii).
- ¹¹ Section 582 allows a bank, as defined in section 581, to report worthless stock of a bank subsidiary as ordinary losses, notwithstanding section 165(g)(3), and to claim a bad debt deduction for worthless debt securities, notwithstanding section 166(e). But when the taxpayer is not a bank, the treatment of worthless securities issued by a bank subsidiary is subject to section 165(g)(3). See, e.g., PLR 9218038 (Jan. 1, 1992).
- ¹² The ruling cites S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.
- ¹³ See GCM 39746 (Aug. 8, 1988).
- ¹⁴ Pub. L. No. 753, section 123(a)(1), 56 Stat. 798, 820 (1942).
- ¹⁵ S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543.
- ¹⁶ "The legislative history indicates the purpose of section 23(g)(4) [of the Internal Revenue Code of 1939] was to allow a parent corporation to claim an ordinary loss deduction for the stock of its subsidiary if it becomes worthless, regardless of whether the parent and subsidiary file a consolidated return or not." PLR 200924040 (June 12, 2009), citing S. Rep. No. 77-1631, 77 Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543. In keeping with the idea of treating closely related corporations as one, the initial ownership test, which required at least a 95 percent ownership, was relaxed in 1971 to permit a subsidiary to qualify as an "affiliated corporation" when the ownership test of section 1504(a)(2) (ownership of at least 80 percent of vote and value) for filing consolidated returns is satisfied.
- ¹⁷ GCM 39746, quoting S. Rep. No. 1530, 91st Cong., 2d Sess. 2 (1970), part of the legislative history underlying a 1971 amendment to section 165(g)(3).
- ¹⁸ S. Rep. No. 1530, 91st Cong., 2d Sess. 2 (1970).
- ¹⁹ *Id.*, quoting the comments of Senator Davis made in connection with 1944 amendments, sponsored by him, to the predecessor of section 165(g)(3), which added the language still in section 165(g)(3)(B) that excludes from prohibited gross receipts rents from rentals to employees in the corporation's ordinary course of business and interest earned on deferred purchase price of operating assets sold.
- ²⁰ As originally enacted in 1942, the gross receipts test was expressed as requiring more than 90 percent of the issuer's gross incomes from all taxable years to be other than income from passive sources. When it was enacted as section 165(g)(3)(B) as part of the 1954 Code, "incomes" was changed to "receipts."
- ²¹ *Commissioner v. Adam, Meldrum & Anderson Co.*, 215 F.2d 163, 166 (2d Cir. 1954), *aff'g* 19 T.C. 1130 (1953).
- ²² It may be more accurate to say parents of insurance subsidiaries with worthless securities were admitted to the world of ordinary losses, only to be tossed out a few years later. See FSA 1159, Vaughn #1159 (Jan. 25, 1994) and TAM 9538005 (Sept. 22, 1995). But see TAM 9723011 (June 6, 1997) in which the Service announced its reconsideration of TAM 9538005 and TAM 9817002 (Jan. 5, 1998) in which the Service revoked TAM 9538005.
- ²³ *Id.*
- ²⁴ See PLR 9218038 (Jan. 29, 1992).
- ²⁵ See PLR 200003039 (Jan. 24, 2000).
- ²⁶ As the PLR notes, banks that own worthless securities of bank subsidiaries may rely on section 582 to support claiming ordinary losses but nonbank owners must resort to section 165(g)(3).
- ²⁷ Another example of where the Code treats income normally considered passive in nature as not passive when earned by an insurance company as part of the conduct of its insurance business is found in section 1297, which addresses passive foreign investment companies ("PFICs"). Although a foreign corporation that derives at least 75 percent of its gross income in any taxable year from passive sources such as interest and dividends is subject to the PFIC regime, which generally taxes to the PFIC's shareholders the foreign corporation's undistributed taxable income, passive income "derived in the active conduct of an insurance business by a corporation which is predominately engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation" is not counted as passive source income for purposes of determining if the foreign corporation has derived at least 75 percent of its gross income from passive sources.
- ²⁸ See FSA 1159 (Jan. 25, 1994).
- ²⁹ TAM 9538005 (Sept. 22, 1995).
- ³⁰ *Id.*, quoting S. Rep. No. 93-1061, 93d Cong., 2d Sess. 3 (1974).
- ³¹ As acknowledged by the Service in TAM 9538005, it is certainly possible that a company claiming to be an insurance company under the Code will be determined to have as its primary and predominant activity the making of investments and not the issuance or reinsurance of insurance contracts. See, e.g., *Inter-American Life Ins. Co. v. Commissioner*, 56 T.C. 497 (1971), *aff'd*, 469 F.2d 697 (9th Cir. 1972). See also TAM 200824029 (June 13, 2008). In such a situation, it would be appropriate to treat the receipts from passive sources as excessive passive source gross receipts under section 165(g)(3)(B).
- ³² TAM 9538005, *infra*.
- ³³ See TAM 9723011 (June 6, 1997).
- ³⁴ TAM 9817002 (April 24, 1998).
- ³⁵ *Id.*
- ³⁶ *Id.*
- ³⁷ See Treas. reg. § 1.817-4(d).
- ³⁸ Compare PLR 200924040 (June 12, 2009), in which the Service concluded that, because the purpose of the gross receipts test is to separate operating companies from investment companies, the royalties earned by a software development company for the use of its proprietary software would not be treated as passive source gross receipts for the purpose of the gross receipts test of section 165(g)(3)(B) because the company was engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software. The "look-through" test of TAM 9817002 was not mentioned or applied.
- ³⁹ See TAM 8939001 (June 9, 1989).



DEFERRED COMPENSATION NOT DEDUCTIBLE IN UNPAID LAE

By Deborah Walker, Mary Gillmarten and
Yvonne Fujimoto

The Internal Revenue Service (“the Service” or “IRS”) recently released Technical Advice Memorandum 200939019 (“the TAM”). The TAM initially caused a stir among some in the insurance tax industry because it disallows a tax deduction that was permitted on the NAIC¹ Annual Statement (hereinafter “NAIC statement”). Specifically, the TAM states that unpaid loss adjustment expenses (“LAE”) for retiree medical benefits may only be deducted in the tax year in which the benefits are included in income by the employee who earned the benefits, despite the fact the amounts were properly included on the NAIC statement and regardless of deductibility of the unpaid LAE under the Internal Revenue Code (“the Code”).²

The Taxpayer in the TAM was an affiliated group of nonlife insurance companies that provided retiree medical benefits to its claims personnel. The TAM states that the retiree medical benefits qualified as deferred compensation and were, therefore, subject to the deductibility limitations of section 404(a)(5) of the Code. However, the TAM is most notable for what it does not discuss, rather than what it does discuss. While some taxpayers might claim that the brightness of the line the TAM presents for broadly applying section 404(a)(5) is not actually as vivid, or as straight, as the TAM appears to reflect,³ the TAM illustrates the risk that the IRS can and will assert Code provisions that it believes are inconsistent with the NAIC statement.

A SUMMARY OF THE TAM

The facts in the TAM are straightforward. The Taxpayer is a U.S. parent company. Together with certain of its affiliates—all of which are property and casualty insurers—it files a consolidated federal income tax return (collectively referred to hereinafter as “the Taxpayer”). The Taxpayer provides retiree medical benefits to its claims personnel. For the two years at issue in the TAM, the Taxpayer included in its calculation of unpaid LAE, the discounted amount of the actuarially determined future retiree medical benefits to be provided to claims personnel. The right to these benefits had been earned by the employees through the performance of services in 2005 and 2006. Benefits will be paid as medical benefits are needed

in retirement. The Taxpayer represented that the unpaid LAE amounts were not contributed to a welfare benefit fund as defined in section 419(e).

The IRS identified the issue in the TAM as whether the Taxpayer was entitled to deduct “anticipated future retiree medical benefits” for claims personnel as unpaid LAE in determining its losses under section 832(b)(5), or whether section 404(a)(5) precludes deductibility of such amounts until the year in which retiree medical benefits are includable in gross income of the employee receiving the benefits. The TAM concludes that section 404(a)(5) “trumps” the provisions of subchapter L (sections 801- 848) and, therefore, the amounts were not currently deductible as losses incurred.

The IRS then set forth the statutory and regulatory provisions it considers relevant to a determination as to which deduction timing rules apply in this case: the rules of subchapter L specifically applicable to insurance expenses or the rules of subchapter D that are generally applicable to deferred compensation and benefits.

SUBCHAPTER L AND THE TAXPAYER

Basically, the statutory scheme for taxing insurance companies has evolved since the adoption of the income tax in 1913 as a creature unto itself,⁴ with special provision upon special provision that frequently create irritation when they come into contact with noninsurance provisions of the Internal Revenue Code.⁵

Since 1921, insurance companies have been subject to special tax provisions of great complexity, which can be understood only in the context of the industry’s financial practices and are not susceptible to examination in a work intended for general consumption.⁶

This is one case that demonstrates the importance of a holistic view of the U.S. tax system and presents one circumstance in which tax professionals are forced to consider which set of rules prevails over another when more than one arguably applies to a specific set of facts.

Part II of Subchapter L of the Code provides the tax rules applicable to property and casualty insurance companies; it defines taxable income for such companies as gross income⁷ less deductions allowed by section 832(c). Section 832(b) provides that gross income of a property and casualty insurance company includes the combined gross amount earned from investment income and underwriting income, “*computed on the basis of the annual statement approved by the National Association of Insurance Commissioners.*” [Emphasis added.] Treasury Regulation section 1.832-4(a)(2) provides:

The underwriting and investment exhibit [of the NAIC annual statement] is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose.

Thus, taxpayers computing their taxable income under section 832(b) must first compute the sum of investment income⁸ and underwriting income,⁹ and then deduct allowable expenses as provided in section 832(c) using the methodology approved by the NAIC. Section 832(b)(3) provides that underwriting income consists of the premiums earned on insurance contracts during the taxable year, *less losses incurred and expenses incurred.* [Emphasis added.] Accordingly, earned premiums reduced by losses incurred and expenses incurred equals underwriting income. A property and casualty insurance company computes gross income by adding the underwriting income thus obtained to investment income. It then reduces this gross income amount by deductions permitted to reach net taxable income.

Section 832(b)(5) defines “losses incurred” in relevant part as an amount equal to the losses paid during the taxable year, plus all unpaid losses on life insurance contracts and *all discounted unpaid losses (as defined in section 846)*, outstanding at the end of the taxable year. [Emphasis added.] Section 832(b)(6) provides that “expenses incurred” do not include any unpaid LAE shown on the annual statement—that unpaid LAE shown on the annual statement are to be included in unpaid losses. Section 846(f) states that the term “unpaid losses” includes any unpaid LAE shown on the annual statement.

The Taxpayer in this TAM appropriately included expenses associated with the unpaid retiree medical expenses for its claims personnel in unpaid losses on its annual statement filed with the NAIC. As a result, in compliance with sections

846(f) and 832(b)(6), the Taxpayer included these amounts in unpaid losses on its federal income tax return for the years at issue. In accordance with section 832(b)(3), this inclusion reduced underwriting income and therefore gross income of the Taxpayer. The IRS conceded in the TAM that the Taxpayer’s inclusion of estimates of its liabilities for retiree health benefits in unpaid LAE (and thus in unpaid losses) on the NAIC statement was appropriate. LAE are not defined in the Code or the regulations for tax purposes; therefore, taxpayers generally must rely on the guidance provided by the NAIC for purposes of the annual statement. Furthermore, because neither the Code nor the treasury regulations specifically define LAE, there is, arguably, no opportunity for the NAIC statement to be “inconsistent with the provisions of the Code” on this point. As noted above, the Taxpayer in the TAM included the discounted amounts for retiree medical benefits as unpaid losses on the NAIC statement and, following sections 832(b)(6) and 846(f), used the amount of unpaid losses on its NAIC statement to reduce underwriting income in computing taxable income under section 832(b).

Thus, looking at those provisions in isolation, it would appear that the Taxpayer had no choice but to include these amounts in LAE in the computation of its taxable income. So why, then, did the IRS disallow the Taxpayer’s inclusion of unpaid LAE attributable to the retiree medical benefits of its claims personnel?

SECTION 404 AND CURRENT DEDUCTIONS FOR DEFERRED BENEFITS

An Overview of Section 404 of the Code

Section 404(a) provides that if compensation is paid or accrued on account of any employee under a plan deferring the receipt of compensation, the compensation is not deductible under chapter 1 of subtitle A of the Code; but if the compensation would “otherwise be deductible,” it is deductible under section 404 subject to the limitations imposed thereunder as to the amounts deductible in any year. Section 404(a)(5) provides that compensation paid under a “nonqualified plan of deferred compensation”¹⁰ is deductible in the taxable year in which the employees participating in the plan include in gross income an amount attributable to the contribution.¹¹

Future Retiree Medical Benefits

Section 404(b) generally disallows a deduction by an employer for a contribution paid under a “nonqualified plan of

CONTINUED ON **PAGE 28**

deferred compensation” until the employee includes the value of the compensation in taxable income. These rules generally follow the “usual requirements of the tax law for deductibility (for example, the item must be an ordinary and necessary business expense or an expense with respect to property held for the production of income).”¹² In 1984, Congress had two fundamental concerns regarding deferred compensation. One was that an employer might “promise” to pay an employee or independent contractor with future compensation and claim a current deduction under the “usual requirements of the tax law for deductibility” without a matching inclusion in income by the employee. The second was that an employer might promise an employee a deferred benefit (such as retiree medical benefits) and claim a current deduction. Congress addressed both concerns by amending section 404(b) to include future benefits in the definition of deferred compensation for purposes of limiting deductibility under section 404(a)(5).

Treasury promulgated temporary regulations in 1986 (modified in 1992) establishing a presumptive period after which a payment is deemed to be deferred compensation for purposes of chapter 1 of the Code. Treasury Temp. Reg. section 1.404(b)-1T, Q&A-2(b)(1) provides that if compensation or benefits are received more than 2 ½ months after the end of the employer’s taxable year in which the services giving rise to the right to receive such compensation or benefits are performed, then such plan, method, or arrangement is presumed to be a deferred compensation or deferred benefits program.¹³ Thus, the IRS concluded that the retiree medical benefits earned by the Taxpayer’s claims personnel qualified as deferred benefits, regardless of any other characterization as unpaid LAE under subchapter L.

Congress also expanded the application of section 404(a)(5) to apply in the absence of a formal plan of deferred compensation to a “method or arrangement of compensation which has the effect of a plan deferring receipt of compensation.”¹⁴

The Act [DEFRA 1984] provides generally that whether or not the deferral of compensation takes place under a benefit plan, rather than a compensation plan, is immaterial for the purpose of determining whether the deduction-timing rules of section 404 apply to the plan. Under the Act, any plan, method, arrangement providing for deferred benefits for employees, their spouses, or their dependents is to be treated as a plan deferring the receipt of compensation. The test is to be applied by determining

whether a benefit would, if considered to be compensation, be considered to be deferred compensation. A benefit that would be considered deferred compensation under this test is a deferred benefit.¹⁵

Congress wished to emphasize that the special rules governing employer deductions with respect to deferred compensation are provided in lieu of the general deduction timing rules of the Code relating to compensation and that their applicability should be carefully considered in all cases involving the timing of deductions with respect to compensation for services.¹⁶

Still concerned about potential abuses in the deduction-timing rules for deferred compensation and benefits,¹⁷ Congress enacted a clarifying amendment to section 404 in the Tax Reform Act of 1986,¹⁸ which eliminated references to sections 162 and 212¹⁹ in section 404(a) and replaced them with “under this chapter; but if they would otherwise be deductible...,” thereby broadening the limitations on deductibility of section 404 to the entire chapter of the Code. The Senate Report stated with respect to this “clarifying amendment:”

The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby accelerate the timing of the deduction for such compensation.²⁰

Section 832 had not been referenced in prior versions of section 404(a); therefore, Congress had no reason to specifically mention it when broadening section 404. How did the IRS conclude that unpaid LAE constituted deferred benefits such that the inclusion of said amount on its tax return would be subject to section 404(a)(5)?

This is one area where the TAM is silent. The facts do not provide a detailed description of the transaction giving rise to the tax issue. The TAM states only that actuarially determined and discounted amounts associated with future retiree medical benefits earned by claims personnel were included in

unpaid LAE. There is no mention of a policy being issued or a premium being paid to cover the employer's liability for these benefits. Rather, this arrangement is an unfunded, unsecured promise to pay benefits in the future, *i.e.*, deferred compensation. This is distinguished from Rev. Rul. 92-93 where the IRS concluded that a life insurance company could issue life insurance contracts on its own employees and increase reserves to reflect the assumption of those life risks.

Had the benefits been insured, the IRS would have followed the conclusions it reached in two private letter rulings—PLRs 9245006 and 9752061—that an insurer's risk of uncertainty as to its funding obligation for retiree health benefits qualifies as a noncancellable accident and health (“A&H”) contract risk.

In PLR 9245006, a life insurance company marketed a policy that indemnified an employer-policyholder for retiree health benefit liabilities incurred under the policyholder's health plan. The policy specified either a single premium or multiple premium payments to be made by the employer-policyholder on the date or dates specified in the policy. The insurer reported the policy as a group A&H insurance contract on its annual statement filed with the state insurance commissioner. The Service concluded that the policy was a noncancellable A&H insurance contract for federal tax purposes and that the reserves required in addition to the unearned premium reserve qualified as life insurance reserves under section 816(b). The IRS reached the same conclusion in PLR 9752061.

If the TAM had presented an insured arrangement, the analysis could have been different. Instead, the TAM concludes that unpaid LAE associated with unfunded promises to employees are deferred benefits under Treas. Temp. Reg. section 1.404-1T, Q&A-2(b)(1).

THE CLASH OF THE TITANS

The Taxpayer's situation presented a “perfect storm” for the clash of section 404 and its general policy of matching deductions for deferred compensation and benefits with the specific tax accounting rules applicable to the insurance industry. The Taxpayer argued first that because the future retiree medical benefits were includible in unpaid LAE under the NAIC statement, the tax treatment of those costs was controlled by subchapter L. Second, the Taxpayer argued that under section 832(b) of subchapter L, unpaid LAE are a component of gross income rather than a deduction and that section 404(a)(5) gov-

erns the timing of deductions and is therefore inapplicable to the calculation of taxable income under section 832.

In its analysis, the IRS addressed the Taxpayer's first argument by conceding that the annual statement required by the NAIC is the starting point for determining taxable income of insurance companies, including the amount of discounted unpaid losses on insurance contracts; and that the term “unpaid losses” includes unpaid LAE as shown in the annual statement. However, the IRS emphasized the “broad scope of the deduction timing rules of section 404” and concluded that “even if Taxpayer is correct in its assertion that the unpaid loss adjustment expenses would ordinarily be taken into account as part of its losses incurred under section 832(b)(5), the deduction timing rules in section 404(a)(5) take precedence.”

The IRS rejected the Taxpayer's second argument as “not persuasive” and “inconsistent with the manner in which ‘losses incurred’ are generally characterized.” The IRS bolstered its “generally characterized” statement by citing section 832(c)(4), which refers to losses incurred as one of the “deductions allowed” in computing the taxable income of an insurance company, and Treas. Reg. section 1.832-4(b), which specifically states that every insurance company taxable under section 831 must be prepared to establish that the part of the “deduction for ‘losses incurred’ which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses.” The IRS then cited court cases wherein losses incurred were at issue and the court characterized losses incurred as a deduction for tax purposes.²¹

AN INTERESTING EXCEPTION FOR HEALTH CARE PROVIDERS

In TAM 9723005 (Feb. 6, 1997), the IRS addresses the same issue involved in the subject TAM—whether the deduction timing rules of section 404 took precedence over the rules of subchapter L—but the facts were different. The taxpayers in the 1997 TAM were an affiliated group of health maintenance organizations (“HMOs”) that were taxed as nonlife insurance companies. The payments at issue were certain “risk

In PLR 9245006, a life insurance company marketed a policy that indemnified an employer-policyholder for retiree health benefit liabilities incurred under the policyholder's health plan.

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withholds” and “surplus distributions,” amounts prescribed in the HMO’s individual provider agreements with various physicians and other health care providers. The taxpayers included the amounts in incurred but unpaid claims reserves and reported the amounts as deductions on the taxpayers’ NAIC statements. The IRS went through the same analysis presented in the subject TAM and reached the same conclusions—that the amounts in question qualified as deferred compensation under section 404 and, therefore, the deductibility-timing rules of section 404(a)(5) took precedence over the rules of subchapter L with respect to the timing of reserve deductions.

In the 1997 TAM, the IRS raised the possibility of the taxpayer rebutting the presumption that the “risk withholds” and “surplus distributions” were deferred for at least 2 ½ months after the close of the HMO’s taxable year in which the amounts were earned.²² The IRS stated that the taxpayer did not provide any information to rebut the presumption of deferred status:

The taxpayer may rebut the presumption established under the previous subparagraph with respect to an amount of compensation or benefits only by setting forth facts and circumstances the preponderance of which demonstrate that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2 ½ month period and that, as of the end of the employer’s taxable such impracticability was unforeseeable.²³

The subject TAM did not discuss or even cite Rev. Proc. 2004-41, 2004-2 C.B. 90. That revenue procedure sets out the circumstances under which an insurance company that makes incentive payments to health care providers will be permitted to include those payments in discounted unpaid losses without regard to the deductibility-timing rules of section 404.²⁴ In the revenue procedure, the IRS acknowledged the following:

Applying section 404 and the regulations thereunder to incentive payments made by the taxpayers would create a substantial administrative burden for the taxpayers and the Service, since the liabilities for incentive payments shown on the annual statements filed by the health insurance companies and HMOs generally are not broken down into amounts that will be owed to specific health care providers.

Rev. Proc. 2004-41 addressed an extremely narrow set of facts, a very specific administrative difficulty with limited application to other taxpayers. Although it is not clear from the revenue procedure or the two TAMs (the subject TAM and the 1997 TAM) what constitutes an administrative burden significant enough to warrant an exception to the application of section 404, it is clear the IRS will consider such situations.

CONCLUSION

The taxation of insurance companies is complex, specialized, and generally self-contained in subchapter L of the Code. There are instances, however, when it becomes necessary to determine how the provisions of subchapter L and tax rules of more general applicability work in conjunction with each other. TAM 200939019 presents one such circumstance. The IRS has taken the position that the deduction-timing rules applicable to deferred compensation and benefits consider and negate the deduction-timing rules contained in subchapter L with respect to the LAE that were the subject of the TAM.

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END NOTES

- ¹ National Association of Insurance Commissioners.
- ² Unless otherwise indicated, all references to section are to the Internal Revenue Code of 1986, as amended ("the Code").
- ³ See TAM 9723005 (February 6, 1997) and Rev. Proc. 2004-41, discussed *infra*.
- ⁴ The first insurance company specific rules entered the Code in 1921.
- ⁵ "While there are many who complain that the Internal Revenue Code is incomprehensible, there are some few who revel in the intricacies of its labyrinthine composition. But those who take delight in such pursuits and who also understand the mystic processes of establishing reserves in the life insurance industry are an even rarer specie of the ornithological world. Such are the vagaries of assignments, however, that it has fallen to the lot of this panel to decide a case where the two sciences conjoin. We therefore tread into the thicket with some trepidation." *The Mutual Benefit Life Insurance Co. v. Commissioner*, 488 F.2d 1101 (3rd Cir. 1973).
- ⁶ B. Bittker and L. Lokken, *Federal Taxation of Income, Estates and Gifts* (2009), RIA, para. 99-7. See also, *Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971) (discussion of the complexities of subchapter L and the policy supporting the special rules).
- ⁷ Section 832(b).
- ⁸ Section 832(b)(2).
- ⁹ Section 832(b)(3).
- ¹⁰ A plan to which the contributions are not deductible under section 404(a)(1), (2), or (3).
- ¹¹ See also, Treas. Temp. Reg. section 1.404(b)-1T, Q&A-1.
- ¹² Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (H.R. 4170, 98th Cong., P.L. 98-369), (December 31, 1984) pp. 804-806.
- ¹³ See also, Treas. Temp. Reg. section 1.404(b)-1T, Q&A-2(a) (a deferred compensation plan, method, or arrangement is one under which an employee receives compensation or benefits "more than a brief period" after the end of the employer's taxable year in which the services creating the right to receive such compensation or benefits are performed).
- ¹⁴ P.L. 98-369, section 512(a) (1984).
- ¹⁵ *Id.*
- ¹⁶ *Id.*
- ¹⁷ Section 404(b)(2) provides that any plan providing for deferred benefits (other than compensation) for employees, their spouses, or their dependents shall be treated as a plan deferring the receipt of compensation. In the case of such a plan, for purposes of this section, the determination of when an amount is includible in gross income shall be made without regard to any provisions of this chapter excluding such benefits from gross income.
- ¹⁸ P.L. 99-514.
- ¹⁹ Relating to trade or business expenses and expenses for the production of income, respectively.
- ²⁰ S. Rep. No. 313, 99th Cong., 2d Sess., 1013, May 29, 1986.
- ²¹ See e.g., *Western National Mutual Insurance Company v. Commissioner*, 102 T.C. 338, 343-44 (1994), aff'd, 65 F.3d 90 (7th Cir. 1995); *Maryland Deposit Insurance Fund Corp. v. Commissioner*, 88 T.C. 1050, 1057-1058 (1987); *Minnesota Lawyers Mutual Insurance Co. v. Commissioner*, T.C.M. 2000-203, aff'd, 285 F.3d 1086 (8th Cir. 2002).
- ²² See, Treas. Temp. Reg. section 1.404-1T, Q&A-2(b)(1), *supra*.
- ²³ Treasury reg. sec. 1.404-1T, Q&A-2(b)(2).
- ²⁴ The revenue procedure also provided procedures under which a taxpayer may obtain automatic consent of the Commissioner to change its method of accounting for such payments.

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ACLI UPDATE COLUMN

By Walter Welsh and Mandana Parsazad

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NOTICE 2009-47: SECTION 7702 AND AGE 100 INSURED

In May 2009, Treasury and the Internal Revenue Service (IRS) issued Notice 2009-47 (“Notice”) with proposed safe harbors regarding the application of the computational rules of sections 7702 and 7702A to a contract with mortality guarantees based on the 2001 CSO Mortality Tables. In October 2009, ACLI submitted a letter in response to the request for comments in the Notice. ACLI and its members appreciate that the notice provided proposed rules and an opportunity for comment. The intersection of the rules of section 7702 and a new mortality table is an area where actuaries and tax professionals must come together and the issuance of rules in proposed form provides an opportunity to develop the most workable rules.

ACLI endorsed the use of the recommendations of the 2001 CSO Maturity Age Task Force of the Society of Actuaries’ Taxation Section in the Proposed Safe Harbor. In particular ACLI urged Treasury and IRS to finalize and publish the list of age 100 testing methodologies in section 3.02(a)-(h) of the Proposed Safe Harbor, subject to some technical suggestions offered. In this connection, ACLI recommended that the Proposed Safe Harbor be limited to life insurance contracts that a) contain mortality rate guarantees which are based on the 2001 CSO Tables (or any successor prevailing mortality tables) and b) may continue in force beyond the insured’s age 100.

ACLI’s letter contrasted these useful computational rules with the proposed rule in section 3.02 (i) of the Notice, that a contract be required to provide at all times a death benefit equal to or greater than 105 percent of the cash value. ACLI’s letter questioned whether basing the 105 percent corridor requirement on case law requiring an insurance contract to exhibit risk shifting and risk distribution was correct. The *Helvering v. Le Gierse*¹ case should not apply to a contract that complies with section 7702, provides material insurance

coverage during an insured’s life, and ceases to have a net amount at risk in the rare circumstance in which the insured survives to a very late age. The letter also pointed out that the rules of section 7702 and section 72 should govern the taxation of distributions from life insurance contracts rather than the general constructive receipt doctrine (*see* Treas. Reg. § 1.451-2(a)).

NEED FOR GUIDANCE ON COMBINED ANNUITY AND LONG-TERM CARE CONTRACTS

Even though Congress permitted life insurance companies to issue annuity contracts that include qualified long-term care insurance coverage as part of the Pension Protection Act of 2006,² companies, Treasury and IRS are just now getting around to discussing the fine points of how the federal tax rules should apply to premiums, application of insurance charges, payment of benefits and surrender of the contract. Although the legislative history provides assistance with a number of questions regarding the tax consequences to policyholders who purchase combination annuity/long-term care insurance contracts, there are other issues for which there is currently no guidance available.

ACLI and its member companies have been identifying a number of issues in need for guidance on the federal tax treatment for annuity/long-term care combination contracts. ACLI plans to ask for guidance to confirm that:

- All premiums paid into an annuity/long-term care insurance contract will be included in the investment in the contract consistent with §72(e)(11).
- The investment in the contract will be reduced by the long-term care insurance charges that are imposed.
- Amounts received as qualified long-term care benefits will be excluded from gross income under §104(a)(3).
- The payment of long-term care benefits under a combina-

tion contract does not cause a reduction in the investment in the contract, without regard to whether the payment causes a reduction in the contract's cash value.

- Taxpayers may engage in a partial exchange of an annuity contract for qualified LTC insurance.

ACLI has met with Treasury and IRS to begin the discussion, and believes that Treasury and IRS will issue guidance on a number of these questions. ACLI also believes that guidance on some of the more novel issues may be published in proposed form. ◀

END NOTES

¹ 312 U.S. 531 (1941).

² P.L. 109-280, §844 (c) and (f).

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T³: TAXING TIMES TIDBITS

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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 165¹ 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. 2009-13⁵—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 Deficiency² 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

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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 2008-18³ 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. ◀

IRS FINDS RISK DISTRIBUTION IN TWO REINSURANCE ARRANGEMENTS

By Janel C. Frank and Gregory K. Oyler

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-

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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.

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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. ◀

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