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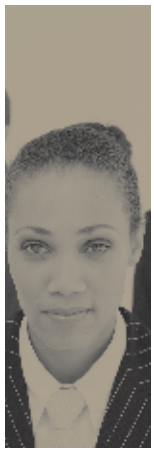

HOW ARE TAX RESERVES FOR VAGLB DETERMINED FOR PRE-2010 CONTRACTS?

By Peter H. Winslow and Michael LeBoeuf

In March 2010, the Internal Revenue Service (IRS) issued Notice 2010-29,[1] which provided interim guidance on tax reserve issues that arise from the NAIC's adoption of Actuarial Guideline (AG) 43 relating to reserves for variable annuity contracts with guaranteed benefits. AG 43 was effective on Dec. 31, 2009, and superceded all prior NAIC actuarial guidelines for these contracts. Notice 2010-29 provides generally that, for purposes of computing the amount of federally prescribed reserves under I.R.C. § 807(d)(2), the provisions of AG 43 for determining the Standard Scenario Amount are taken into account, but not those for determining the Conditional Tail Expectation (CTE) Amount. While the interim guidance from the IRS was timely and welcome, it left open several important issues, including whether the CTE Amount is includible in statutory reserves under I.R.C. § 807(d)(6) for purposes of determining the limitation on the amount of deductible tax reserves.

Another important issue not addressed in Notice 2010-29 is how tax reserves should be computed for contracts issued prior to Dec. 31, 2009. Although AG 43 applies for statutory reserve purposes to variable annuity contracts issued on or after Jan. 1, 1981, Notice 2010-29 states that AG 43 will apply for tax purposes only to contracts issued on or after Dec. 31, 2009. For previously issued contracts, the Notice states that "the tax reserve method under § 807(d)(2)(A) and (d)(3) is the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43." Presumably, the IRS would conclude that the relevant guidance is AG 34 for guaranteed minimum death benefits (GMDB) provided under variable annuities, at least for contracts issued after AG 34's effective date. But what about guaranteed minimum living benefits?

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FROM THE EDITOR
GUIDANCE MATTERS

By Christian DesRochers

The *Taxing Times* editorial staff never seems to lack for ideas for article topics. One of the sources that we use to plan the content of upcoming issues is the Treasury's *Priority Guidance Plan*. On Dec. 7, 2010, the Department of the Treasury published its 2010-2011 *Guidance Plan* that will be used to set priorities for allocating resources during the 12-month period from July 2010 to June 2011. The *Guidance Plan* includes nine projects directed at insurance companies and insurance projects, including two where guidance has already been published.

The two topics for which guidance has already been provided include:

- The treatment of post-age 100 maturity under §7702 based on comments to Notice 2009-47 (published 08/23/10 in IRB 2010-34 as Revenue Procedure 2010-28).
- Guidance under §833 as modified by the *Patient Protection and Affordable Care Act* (published Dec. 6, 2010 in IRB 2010-49 as Notice 2010-79 — released Nov. 22, 2010). Section 833 provides special rules for certain Blue Cross and Blue Shield organizations.

The *Guidance Plan* for 2010-2011, carries over a number of projects from the 2009-2010 *Guidance Plan*, including:

- Final regulations under §72 on the exchange of property for an annuity contract (proposed regulations were published on Oct.18, 2006).
- Guidance on annuity contracts with a long-term care insurance feature under §§72 and 7702B.
- Guidance on the tax-free exchange of life insurance contracts subject to §264(f).
- Guidance clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6).
- Guidance on the determination of the company's share and policyholders' share of the net investment income of a life insurance company under §812.
- Guidance under §1035 on the tax treatment of a partial exchange of an annuity contract.
- One new item added to the *Guidance Plan* for 2010 and 2011 includes guidance under §7702 defining cash surrender value.

Most of these issues have already been the topic of articles in *Taxing Times*. In fact, Revenue Procedure 2010-28 cites a *Taxing Times* article documenting the work of the Taxation Section 2001 CSO Maturity Age Task Force. (*See* "2001 CSO Implementation Under IRC Sections 7702 and 7702A," 2 *Taxing Times* 23 (May 2006)).

As guidance is published, we will continue to produce articles on the topics of interest to our readers. In the meantime, please enjoy this issue which features articles on the emerging international accounting rules, variable annuity living benefit reserves, and discussions of recent guidance on both company and policyholder issues. Thanks to all of our authors, commentators, editorial board and editors who make *Taxing Times* the valuable publication it is.

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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.

—Christian DesRochers

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FROM THE CHAIR
TAXATION SECTION UPDATE

By Steven C. Chamberlin

The year is going by quickly, but your section has been busy with a variety of activities. Here are a few highlights.

As always, our section provides many education opportunities to help members meet the SOA Continuing Professional Development (CPD) requirements. The first such effort in 2011 was a Tax Reserves Seminar held in Orlando in March. Guidance on tax basis reserves was the primary area covered, and attendees also learned about tax issues in reinsurance, company share, statutory deferred taxes and challenges associated with principle-based reserves. The section recognizes that many actuaries don't have formal training in this area, and there are always new developments. We would like this seminar to become a fixture on the SOA calendar every couple of years.

When you receive this issue of *Taxing Times*, it will be about time for the Life and Annuity Symposium. In addition to a breakfast, our session is cosponsoring three other sessions providing current information with an emphasis on tax issues of interest to product actuaries.

The section expects to sponsor two or three webinars during 2011. We are planning a webinar on retroactivity and the role of actuarial guidelines in early June. Possible webinars for later in the year may focus on tax implications associated with principle-based reserves, or tax issues related to health care reform.

At the Valuation Actuary Symposium, our section will again sponsor a breakfast as well as a session on current tax issues. At the time of this writing, the 2011 SOA Annual Meeting is just beginning to take shape, and we expect to sponsor sessions that discuss valuation, product and health tax issues.

Outside of the CPD realm, our section organized the Necessary Premium Test Task Force last year. This group has created a survey designed to elicit information on how companies' administrative systems are currently applying the necessary premium test. More than 20 companies are represented on the task force, so the survey results should provide some important insights.

Last but not least, our newsletter continues to provide an outstanding range of articles. The Editorial Board works hard to recruit information on current tax topics with actuarial, accounting and legal perspectives.

In closing, I'd like to add that we have a strong group of council members and friends and appreciate all of their hard work and effort. We are always looking for new volunteers, so if you have an interest in a program, or would like to write an article for our newsletter, or simply have an idea for our section to consider exploring, please let me know. Your involvement is important!

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Prior to AG 43, the applicable NAIC guidance for variable annuity contracts with guaranteed minimum living benefits (VAGLB) was AG 39 adopted by the NAIC in 2002. AG 39 was intended to be temporary and by its terms (as amended) was scheduled to sunset no later than Dec. 30, 2009. AG 39 prescribes aggregate reserves for variable annuities with VAGLB as the sum of two components: (1) aggregate reserves for the contracts ignoring both the future revenues and benefits from the VAGLB and after comparison to the cash values of the contracts (Base Reserve); plus (2) the "VAGLB reserve," which is equal to the sum of the aggregate charges for VAGLB in force to the valuation date (Charge Accumulation Reserve) and subject to an asset adequacy analysis. AG 39 requires that the actuary perform the asset adequacy analysis on an aggregate basis that reflects all VAGLB and related expenses, all VAGLB charges and the assets supporting the VAGLB reserve (Asset Adequacy Reserve).

IRS AUDIT POSITION

In current audits, some IRS agents have taken the position that neither portion of the AG 39 statutory VAGLB reserve, component (2) described in the previous paragraph, qualifies to be included in the federally prescribed reserves for tax purposes. This IRS audit position has little impact with respect to the Asset Adequacy Reserve because few companies have attempted to treat the reserve as part of federally prescribed reserves in recognition of the IRS's concerns with the deductibility of principle-based stochastic reserves first expressed publicly in Notice 2008-18.[2] As a result, the audit disputes have focused on the Charge Accumulation Reserve.

IRS auditors who have challenged AG 39 tax reserves have made two basic arguments to disallow the Charge Accumulation Reserve portion. First, they contend that the AG 39 reserves are not life insurance reserves as defined in I.R.C. § 816(b) because they are not computed on the basis of recognized mortality tables and assumed rates of interest. The IRS generally takes the position that a reserve computed on the basis of gross premiums is not a life insurance reserve unless the premiums themselves expressly reflect a recognized mortality table and discount rate.[3] The second argument made by these IRS auditors is that the tax reserve method required by I.R.C. § 807(d) is CARVM and the Charge Accumulation Reserve is not a CARVM reserve because there is no attempt in AG 39 to compute the greatest of the present values of future annuity benefit streams. In support of this contention, the IRS agents have pointed out that AG 39 itself does not specifically refer to CARVM.

Taxpayers have made several arguments to counter these IRS audit positions. In response to the argument that mortality and interest factors are not considered, it has been argued that the Charge Accumulation Reserve qualifies for tax reserve treatment because it is merely a portion of a larger reserve that includes the Base Reserve which is computed using mortality and interest assumptions. Also, the Charge Accumulation Reserve may implicitly take into account mortality and interest factors to the extent they are considered in the mortality and expense charges, or because the Charge Accumulation Reserve was intended by the NAIC to be a temporary estimate of a reserve computed on a tabular basis.[4]

In response to the IRS auditors' argument that AG 39 does not refer to CARVM, taxpayers have pointed out that the guideline states that it is an interpretation of the Standard Valuation Law, which is what specifies CARVM as the prescribed reserve method for variable annuities. So, by definition, however approximate the AG 39 reserve calculation, it is an NAIC-sanctioned interpretation of CARVM.

For post-2009 tax years, the position of the IRS auditors is much stronger if the company continues to use AG 39 for tax purposes for contracts issued prior to Dec. 31, 2009. At the time pre-2010 contracts were issued, AG 39 itself (as amended) provided that it would sunset no later than Dec. 30, 2009. Therefore, the IRS could argue that, although AG 39 was prescribed by the NAIC, it was only prescribed for pre-2010 years. As a result, other actuarial guidance necessarily applies for post-AG 39 tax years. Presumably, this guidance must be a

reasonable interpretation of CARVM at the time the contract was issued. The best pre-2010 guidance is AG 33, which is directly applicable to all variable annuity contracts, and AG 34 may be indirectly applicable by analogy.

AG 33

In recognition that the implementation of CARVM for annuity contracts with multiple benefit streams was not uniform within the industry, especially with respect to elective benefits, the NAIC adopted AG 33.[5] Noting that CARVM requires that reserves be based on the greatest present values of all potential future guaranteed benefits, AG 33 requires that an integrated benefit stream approach be used as follows:

> Under the integrated benefit stream approach, any potential benefit stream must be considered, including blends reflecting the interaction of more than one type of benefit. Such potential benefit streams include all types of benefits for which the greatest present value concept is required. Additionally, adjustments must be made to all such potential benefit streams to reflect those benefit types for which prescribed incidence tables are required (*e.g.,* death benefits).[6]

AG 33 then says the following with respect to determining the greatest present value:

> All guaranteed benefits potentially available under the terms of the contract must be considered in the valuation process and analysis and the ultimate policy reserve held must be sufficient to fund the greatest present value of all potential integrated benefit streams, reflecting all guaranteed elective and non-elective benefits available to the contract owner. Each integrated benefit stream available under the contract must be individually valued and the ultimate reserve established must be the greatest of the present values of these values. . . .[7]

AG 33 is intended "to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams," specifying three sets of integrated benefit streams that must be considered—cash value streams, annuitization streams and other elective benefit streams—each to be considered in a possible blend of future partial and full withdrawals and surrenders, annuitization elections, or combinations of guaranteed elective benefits, and with appropriate recognition of all guaranteed non-elective benefits available under the contract.[8] AG 33 applies to all annuity contracts subject to CARVM where any elective benefits are available to the contract owner under the terms of the contract.

Thus, AG 33 would be the applicable NAIC guidance for computing the CARVM tax reserve for VAGLB provided under these contracts.

By its terms, AG 33 is an interpretation of CARVM. AG 33 provides that, while it applies to all annuity contracts, "in the event an actuarial guideline or regulation dealing with reserves is developed for a specific annuity product design, the product specific actuarial guideline or regulation will take precedence over [AG 33]."[9] VAGLB are guaranteed elective benefits that would be covered by AG 33, but for the development of AG 39. Thus, at least for contracts after AG 33's effective date, the tax reserve method for annuities with VAGLB, which is required by I.R.C. § 807(d)(3), presumably is CARVM as interpreted by AG 33, except to the extent AG 39 applies.

Another way to consider the issue of what is a valid tax reserve computation for pre-2010 variable annuity contracts with VAGLB is to assume that AG 39 must be ignored completely. Where tax reserving requires the use of CARVM, if AG 39 is not CARVM for tax purposes, the existence of AG 39 should not supplant the application of AG 33 for tax purposes with respect to any guaranteed benefits under an annuity contract with VAGLB. Thus, AG 33 would be the applicable NAIC guidance for computing the CARVM tax reserve for VAGLB provided under these contracts.

The IRS has recognized AG 33 as applying for tax purposes under I.R.C. § 807(d)(2) and has disallowed only its retroactive application to reserves on contracts issued prior to the effective date of AG 33.[10] Therefore, if AG 39 does not apply, the IRS presumably would agree that AG 33 is applicable although the IRS has not said so formally.

AG 33 RESERVES FOR VAGLB

If AG 33 is the applicable guidance for pre-2010 contracts with VAGLB, the important question remains: how are these tax reserves to be computed? Clearly, when it was published AG 33 did not directly address how long-tailed liability struc-

CONTINUED ON **PAGE 8**

tures such as VAGLB fit into the integrated benefit stream approach; however, with respect to GMDB, AG 34 introduced a methodology to value such integrated long-tailed liability structures. Therefore, AG 34 can be said to provide by analogy NAIC guidance as to how AG 33 is to be interpreted.

The key assumptions that AG 34 introduced to value GMDB that have direct relevance to VAGLB are the deterministic drop and recovery scenario used to project future account values and utilization of the greatest present value of the worst case results into the integrated benefit streams. These basic principles would seem to be required in developing a tax-basis AG 33 reserve for VAGLB, but they do not provide specific guidance as to the assumptions needed for VAGLB to fit within the AG 34 methodology. For example, because of the nature of the guarantees, the appropriate drop and recovery scenario for GMDB and VAGLB could be much different. Moreover, AG 34 was developed and adopted in the late 1990s and the world has changed much since then. In order to implement a comprehensive, up-to-date tax reserve methodology we also should look to recognized actuarial practice at the time the contracts with VAGLB were issued—typically in the late 2000s. In doing this, guidance from AG 43 for establishing assumptions and methodology for valuing VAGLB may be useful, particularly in light of the IRS's acceptance of the Standard Scenario Amount for determining tax reserves, at least on an interim basis.

Specifically, it seems appropriate to refer to the assumptions underlying the Standard Scenario in AG 43 for VAGLB, with appropriate modifications in order to determine AG 33 tax reserves. This reliance on AG 43 is not the same as applying it retroactively for tax purposes, which is prohibited by Notice 2010-29. AG 43 principles should be considered only to the extent they reflect AG 33 methodology and are consistent with recognized actuarial practice under AG 33 (and AG 34 by analogy) as of the time the contracts were issued. Moreover, for tax years beginning in 2009, reliance on AG 43 Standard Scenario assumptions used for statutory reserves may be required, when they are relevant, to the extent they are not inconsistent with a specific interpretation of AG 33 by 26 state regulators at the time the contracts with VAGLB were originally issued.[11]

Some of those modifications to the AG 43 Standard Scenario to arrive at a tax basis AG 33 reserve might include:

- In establishing the Accumulated Net Revenue under AG 43, only the VAGLB components of the contracts should be considered;
- The account value margin assumptions in the Standard Scenario should be ignored, and only VAGLB fees should be used;
- Only VAGLB claims should be included;
- The value of hedges should be ignored;
- Partial surrenders should be considered; and
- Lapse assumptions should not be used.

Also, it appears that the drop and recovery assumptions under AG 43 are more appropriate for VAGLB than the AG 34 assumptions. That is, because a GMDB typically is available in early contract durations, the larger drop and more rapid recovery assumptions under AG 34 may be less appropriate than the AG 43 assumptions when dealing with VAGLB that are not effective until later contract durations.

Another very important assumption modification from the AG 43 Standard Scenario would be to expand the testing for the greatest present value of the worst case scenario beyond assuming a formula-driven structure for VAGLB election rates. For example, AG 43 would include such assumptions as the exercise of an in-the-money guaranteed minimum withdrawal benefit only at the earliest possible future projection interval. Consistent with AG 33 and the integrated benefit stream approach, the exercise of the VAGLB at all possible future projection intervals should be tested. There are VAGLB designs that exist today where an assumed exercise of an in-the-money guaranteed minimum withdrawal benefit at the earliest possible future projection does not produce a greatest present value. Therefore, following this assumption in the Standard Scenario of AG 43 is a departure from traditional CARVM and would not comply with AG 33 requirements.

Once the AG 33 reserve for VAGLB is computed, the remaining tax reserve requirements would still need to be followed. The AG 33 reserve would need to be aggregated with any other federally prescribed reserves for the contract (AG 34

reserves for GMDB) and then capped by the statutory reserves for the contract. The initial transition to an AG 33 tax reserve could end up producing higher or lower tax reserves for individual policies as compared to AG 39 reserves. The amount of the difference will depend on how close or far to an in-the-money position the VAGLB happens to be in the transition year. It is not out of the question for an out-of-the-money VAGLB to have a near zero additional tax reserve attributable to the VAGLB. This would be unthinkable under AG 39. Conversely, an in-the-money VAGLB may have an appropriately higher tax reserve than under AG 39. Following AG 33, however, will result in a tax reserve approach that is more intuitive and responsive to movements in the market than the simple accumulation of fees under AG 39. Additionally, as part of the transition to AG 33, the increase or decrease in the tax reserve could be incorporated into the AG 43 change in basis under Notice 2010-29.

For insurance companies, this approach to VAGLB tax reserves has several advantages. First of all, there should be an administrative advantage because there is the potential ability to leverage off existing models and processes that currently develop AG 43 reserves to the extent they are consistent with AG 33 and AG 34. Also, companies would have a tax reserve that will move with market conditions, much like AG 43 reserves. This result, where tax and statutory reserves move similarly year to year, will help reduce the company's deferred tax asset, unlike the situation that can exist in an AG 39 tax reserve environment.

CONCLUSION

In an environment where the IRS on audit is rejecting insurance companies' reliance on AG 39 to set tax reserves for VAGLB, the industry is left with a void in its tax compliance that must be filled with an alternative tax reserve method that fits in with the principles of CARVM as of the time the contract was issued. Assuming the IRS's audit position is correct, it seems that the best course of action is to look to our past, AG 33 and AG 34, as well as AG 43 to the extent it is consistent with AG 33 and AG 34, to develop a tax reserve method that is grounded in CARVM principles previously recognized by the NAIC and incorporates the integrated benefit approach that NAIC guidance requires. The authors believe that the method outlined in this article does just this and companies and the IRS should consider this to be a reasonable alternative approach to CARVM as a substitute for AG 39 in the event of an IRS audit, as well as into the future so long as pre-2010 variable annuity contracts remain on the books.

END NOTES

1. 2010-15 I.R.B. 547. *See* Peter Winslow and Christian DesRochers, *Attorney-Actuary Dialogue on Notice 2010-29*, 6 Taxing Times 24 (Sept. 2010).
2. 2008-5 I.R.B. 363.
3. Rev. Rul. 77-451, 1977-2 C.B. 224; Rev. Rul. 69-302, 1969-1 C.B. 186.
4. *See Central National Life Ins. Co. of Omaha. v. United States,* 574 F.2d 1067 (Ct. Cl. 1978).
5. Guideline effective 12/31/1995 for all contracts issued after 1/1/1981. Revisions to guideline effective 12/31/1998 for all contracts issued after 1/1/1981.
6. National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual,* vol. II, at C-83 (Mar. 2008) ("AP&P 2008").
7. AP&P 2008 at C-85.
8. AP&P 2008 at C-85.
9. AP&P 2008 at C-83 to C-84.
10. *See* TAM 200328006 (Mar. 20, 2003). *But see American Financial Group v. United States,* 726 F. Supp. 2d 802 (S.D. Ohio 2010), *appeal docketed,* No. 10-3991 (6th Cir. Aug. 16, 2010).
11. Staff of the Jt. Comm. On Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Reform Act of 1984 599 (Comm. Print 1984).

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THE IRS CONSIDERS MODIFICATIONS TO SEPPs

By Mark E. Griffin

Section 72(t)(2)(A)(iv)[1] sets forth an exception to the 10 percent penalty tax on premature distributions from qualified retirement plans for certain distributions which are part of a series of substantially equal periodic payments ("SEPPs"). However, the penalty tax that is avoided under this "SEPP Exception" generally is recaptured under section 72(t)(4) if the series of SEPPs is modified within five years or before the taxpayer attains age 59½ (the "Recapture Rule"). Similar rules apply to premature distributions from non-qualified annuity contracts under section 72(q).

Rev. Rul. 2002-62[2] provides guidance on what constitutes a series of SEPPs within the meaning of section 72(t)(2)(A)(iv). This revenue ruling also briefly addresses certain circumstances in which the series of payments will and will not be treated as modified for purposes of the Recapture Rule. Aside from these circumstances, there is little guidance in the Code or the legislative history of the SEPP Exception on the extent to which a distribution that differs from others in a stream of SEPPs nevertheless will be treated as covered by the SEPP Exception, and thus will not be viewed as a modification to the stream that triggers the Recapture Rule.

In addition, the Service concluded that the failure to make a distribution as scheduled, and the subsequent make-up payment, would not constitute a modification to the series of SEPPs.

Recently, the Internal Revenue Service (the "Service") in PLR 201051025 (Sept. 30, 2010) concluded that, under the facts of the case, an initial lump sum payment from an IRA which differed in amount from subsequent distributions in a series of SEPPs was covered under the SEPP Exception and did not result in a modification to the series.[3] In addition, the Service concluded that the failure to make a distribution as scheduled, and the subsequent make-up payment, would not constitute a modification to the series of SEPPs. This private letter ruling reflects the Service's willingness to look beyond a strict reading of the Code, legislative history and Rev. Rul. 2002-62 in applying the SEPP Exception and the Recapture Rule. This article discusses the SEPP Exception, looks at whether certain deviations in a stream of SEPPs constitute modifications of the stream for purposes of the Recapture Rule, and considers the Service's conclusions in PLR 201051025.

THE 10 PERCENT PENALTY TAX, THE SEPP EXCEPTION AND THE RECAPTURE RULE

Section 72(t) provides generally that if an employee receives any amount from a "qualified retirement plan"[4] prior to the date on which the employee attains age 59½, the taxpayer's income tax is increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income, subject to certain exceptions. The SEPP Exception in section 72(t)(2)(A)(iv) provides that this 10 percent penalty tax does not apply to distributions which are part of a series of SEPPs (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary. Rev. Rul. 2002-62 provides that distributions will be treated as covered by the SEPP Exception if they are made in accordance with one of the three calculation methods described therein, namely (1) the "required minimum distribution method," (2) the "fixed amortization method," or (3) the "fixed annuitization method." As mentioned earlier, however, the section 72(t)(4) Recapture Rule provides that if a series of payments that is covered by the SEPP Exception is modified (other than by reason of death or disability) within five years or before the employee attains age 59½, the previously avoided 10 percent penalty tax is recaptured in the year of the modification, and the employee's tax for the year is increased by an amount equal to the tax which (absent the SEPP Exception) would have been imposed, plus interest for the deferral period.

The counterparts of these rules for non-qualified annuity contracts are set forth in section 72(q). Specifically, the 10 percent penalty tax on premature distributions from a non-qualified annuity contract is imposed under section 72(q)

(1), the SEPP Exception to this penalty tax is set forth in section 72(q)(2)(D), and the Recapture Rule for a modification to a series of SEPPs under a non-qualified annuity contract is provided in section 72(q)(3). The Service in Notice 2004-15 noted generally that the penalty tax provisions in section 72(q) were enacted by Congress for the same purpose as the penalty tax provisions in section 72(t). Hence, it seems appropriate to apply the SEPP Exception and the Recapture Rule under section 72(q) to non-qualified annuity contracts in the same manner that they are applied under section 72(t) to qualified retirement plans.[5]

WHAT CONSTITUTES A MODIFICATION OF SEPPS FOR PURPOSES OF THE RECAPTURE RULE?

The SEPP Exceptions under section 72(t)(2)(A)(iv) and (q)(2)(D) do not contain waiver provisions under which the Service can forgive a modification to a series of SEPPs that otherwise would trigger the application of the Recapture Rule. Rather, the SEPP Exceptions are drafted such that the Recapture Rules must apply if the series of SEPPs is modified within five years or prior to the date that the taxpayer attains age 59½. The only exception to the Recapture Rule, as articulated in sections 72(t)(4) and (q)(3), is that a modification by reason of death or disability will not trigger the Recapture Rules under those sections.

Aside from these references to modifications by reason of death or disability, neither the Code nor the regulations under section 72 define or discuss what constitutes a modification for purposes of the Recapture Rules. The legislative history of the SEPP Exception under section 72(t)(2)(A)(iv) indicates that payments will not fail to be SEPPs, and thus will not be viewed as resulting in a modification to the series of payments, solely because the payments vary on account of (1) certain cost of living adjustments, (2) cash refunds of employee contributions upon an employee's death, (3) a benefit increase provided to retired employees, (4) an adjustment due to the death of the employee's beneficiary, or (5) the cessation of a social security supplement.[6] Regarding the SEPP Exception under section 72(q)(2)(D), the Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 prepared by the staff of the Joint Committee on Taxation (the "TEFRA Blue Book") states that the requirement that an amount be paid out as one of a series of "substantially equal" periodic payments is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same.[7] Beyond this limited guidance, it has been up to the Service and the courts to interpret what constitutes a modification to a series of SEPPs.

The Service and the courts have demonstrated a willingness in some cases to overlook deviations in a stream of SEPPs for purposes of applying the Recapture Rule. For instance, the Service in Rev. Rul. 2002-62 expressed the following views about whether certain changes in a stream of SEPPs will be treated as modifications for purposes of the Recapture Rule under section 72(t)(4):

1. *Complete depletion of assets*. If, as a result of following an acceptable method of determining SEPPs, an individual's assets in an individual account plan or an IRA are exhausted, the resulting cessation of payments will not be treated as a modification of the series of payments.

2. *One-time change to required minimum distribution method.* An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years, and the change in method will not be treated as a modification within the meaning of section 72(t)(4).

   Observation. The Service's position in Rev. Rul. 2002-62 that a change of method will not be viewed as a modification only if the change is to the required minimum distribution method, and only if the change is made once, appears to be much narrower than the position expressed in the legislative history of the SEPP Exception. The legislative history of section 72(q)(2)(D) indicates that a change of method to any method which satisfies the SEPP Exception should not be treated as a modification, and does not limit the number of times that such a change may occur. Specifically, the Conference Report to the Tax Reform Act of 1986 explains:

   > ... if distributions to an individual are not subject to the [ten percent penalty] tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed *if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception*.

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> ... Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and *alters the distribution method to a form that does not qualify for the exception* prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied.[8] (Emphasis added.)

3. *Certain changes to account balance.* A modification to the series of payments will occur if, after the date SEPPs are first calculated, there is (a) any addition to the account balance other than gains or losses, (b) any nontaxable transfer of a portion of the account balance to another retirement plan, or (c) a nontaxable rollover by the taxpayer of the amount received.

   Observation. The Service has taken the position in Rev. Rul. 2002-62 that any nontaxable rollover (even a rollover of the entire account balance) will result in a modification, and that a nontaxable transfer of a *portion* of the account balance will result in a modification. The revenue ruling is silent on whether a nontaxable transfer of the *entire* account balance will result in a modification. This suggests that the Service might be of the view that a nontaxable trustee-to-trustee transfer of the entire account balance (*e.g.*, from one IRA to another IRA) *will not* result in a modification to a series of payments if the SEPPs continue after the transfer,[9] and yet a nontaxable rollover of the entire interest (*e.g.*, from a section 403(b) contract to an IRA) *will* result in a modification even if SEPPs continue after the rollover.[10]

It should be noted, however, that the Service has concluded in at least two private letter rulings that an inadvertent rollover by a financial institution or IRA custodian of amounts into an IRA from which SEPPs were being made did not result in a modification for purposes of the Recapture Rule.[11] In another private letter ruling, the Service concluded that a partial transfer between two IRAs from which SEPPs were being paid did not result in a modification under the Recapture Rule where the transfer was made by the IRA custodian, without informing the IRA owner, to correct erroneous distributions previously made by the custodian (which also were not treated as modifications to the SEPPs).[12]

Also, the Tax Court in *Benz v. Commissioner*[13] held that a distribution that satisfies the exception to the 10 percent penalty tax for higher education expenses under section 72(t)(2)(E) did not cause a modification to a series of SEPPs where the method of calculating the SEPPs did not change as a result of the additional distribution. In so holding, the Tax Court reasoned as follows:

- An employee may qualify for more than one statutory exception to the 10 percent additional tax. In particular, the last sentence of section 72(t)(2)(E) provides generally that the amount of distributions attributable to higher education expenses does not take into account distributions described in the SEPP Exception.[14] The court explained that if a distribution qualifies for both the SEPP Exception and the section 72(t)(2)(E) exception for higher education expenses, the employee is exempt from the 10 percent penalty tax on the basis of the SEPP Exception, and need only rely on the higher education expense exception for the additional amount of the distribution.

- Citing the legislative history of the SEPP Exception, noted above, the Tax Court stated that a "modification occurs for purposes of section 72(t)(4) when the method of determining the periodic payments changes to a method that no longer qualifies for the exception." In the *Benz* case, the method of calculating the periodic payments did not change as a result of the additional distributions for higher education expenses. The court explained that Congress enacted the Recapture Rule to apply to prior distributions received under a series of periodic payments "where the employee fails to adhere

to the payment schedule elected for at least 5 years."[15] The court added that "[t]here is no indication that Congress intended to disallow all additional distributions within the first 5 years of the election to receive periodic payments."[16]

- The Tax Court observed generally that the legislative purpose of the 10 percent penalty tax under section 72(t) is to discourage premature distributions that frustrate the goal of encouraging saving for retirement. The court found that this legislative purpose "is not frustrated where an employee receives distributions for more than one of the purposes that Congress has recognized as deserving special treatment."

In addition, the Service has issued a number of private letter rulings that take a taxpayer-friendly view of whether modifications to a series of SEPPs has occurred. For example, the Service has ruled in at least two private letter rulings that where an individual was receiving distributions from an IRA that satisfied the SEPP Exception at the time of the individual's divorce, the transfer to the individual's spouse of an interest in the IRA pursuant to the divorce judgment constituted a nontaxable transfer, and the resulting reduction in the SEPPs did not constitute a modification to the series of SEPPs under the Recapture Rule.[17] Also, as is relevant for purposes of PLR 201051025, discussed below, the Service has concluded in several instances that the inadvertent failures to make scheduled SEPP distributions that were not caused by the taxpayer (such as failures on the part of a financial institution, custodian or investment advisor), and the subsequent corrective distributions, did not result in modifications of the series of SEPPs that would trigger the application of the Recapture Rule.[18]

PLR 201051025

The taxpayer in PLR 201051025 was under age 59½ and owned an IRA. The taxpayer established an arrangement with the IRA custodian under which the taxpayer would receive distributions in the form of SEPPs intended to comply with the section 72(t)(2)(A)(iv) SEPP Exception. The amount of the annual distribution under the SEPP Exception, calculated using the fixed amortization method, was Amount 1. The taxpayer directed the custodian to distribute Amount 1 in a single lump sum in Year 1 and in equal monthly installments of Amount 2 thereafter. It is unclear whether the single lump sum distribution in Year 1 was made in the same payment interval as the subsequent monthly payments commencing in Year 2 (*i.e.*, whether the lump sum payment in Year 1 might have been paid more or less than one month prior to the first monthly distribution in Year 2).

In Year 6, the IRA custodian failed to make the 12 scheduled monthly payments of Amount 2, and instead distributed only 11 monthly payments. The taxpayer first learned of this when he noticed that the Form 1099-R for Year 6 that he received from the custodian in Month 3 of Year 7 reported the total amount of distributions for Year 6 equal to only 11 monthly payments of Amount 2, rather than the annual distribution amount of Amount 1. The taxpayer proposed to address this failure by receiving an extra, "make-up" payment of Amount 2 in Year 7.

The taxpayer requested the Service to rule that the fact that the amount of the annual payment computed pursuant to the SEPP Exception (Amount 1) was paid in a single sum in Year 1 and in monthly installments beginning in Year 2 would not be considered a modification to the series of SEPPs. In addition, the Service was asked to rule that the failure to distribute the entire required distribution amount for Year 6, and the proposed make-up distribution for Year 7, would not be considered a modification to the series of SEPPs.

The Service concluded that the failure to distribute the entire required annual payment (Amount 1) for Year 6, and the subsequent make-up distribution in Year 7 would not be considered a modification to the series of SEPPs under the Recapture Rule. This conclusion is not surprising given that the Service has taken a similar position in a number of other instances. As noted above, the Service has concluded in several private letter rulings that the failure to distribute the entire required annual payment amount from an arrangement for a stated calendar year, and the subsequent corrective distribution, did not result in a modification for purposes of the Recapture Rule where the individual taxpayer did all he could in order to ensure that the SEPPs would be distributed, and the inadvertent failure to make the proper distributions was caused by a financial institution, custodian or investment advisor.[19]

The novel aspect of PLR 201051025 is the second ruling, in which the Service concluded that the fact that the amount of the annual payment (Amount 1) was paid in a single sum in Year 1 and in monthly distributions beginning in Year 2 would not be considered a modification to the series of SEPPs under the Recapture Rule. This appears to be the

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first instance in which the Service has addressed whether a change from an annual payment to monthly payments constitutes a modification of SEPPs. The private letter ruling does not provide the Service's rationale for reaching this conclusion. It does indicate, however, the Service's willingness to apply the SEPP Exception by considering the distributions made on a calendar year basis.

This is not to suggest that the total annual amount of SEPP distributions for a calendar year can be made any time or in any installments during the year. The Service has long been of the view that SEPPs must be part of a scheduled stream of payments in order to qualify for the SEPP Exception.[20] In PLR 201051025, the stream of payments included the scheduled single lump payment of Amount 1 in Year 1, followed by the scheduled monthly payments of Amount 2 beginning in Year 2.

> ***Observation.*** It appears that the Service applied the SEPP Exception in PLR 201051025 by considering the payments made on a calendar year basis, rather than by looking at each distribution in the series of payments. Consistent with this observation, the Service did not make an issue of the fact that the IRA custodian in PLR 201051025 distributed the incorrect amount for Months 1 and 2 of Year 2, and subsequently made a corrective distribution (apparently in Year 2). Also, the taxpayer did not request a ruling addressing whether these incorrect payments, and the corrective distribution, resulted in a modification to the series of SEPPs.

CONCLUSION

PLR 201051025 is noteworthy because it demonstrates that the Service will in some cases overlook certain deviations in a stream of SEPPs for purposes of applying the SEPP Exception and the Recapture Rule. The private letter ruling (1) is consistent with the position taken by the Service in other private letter rulings that certain inadvertent failures to make SEPP distributions will not result in modifications under the Recapture Rule, and (2) addressed a situation in which a lump sum payment that is different in amount (and possibly timing) from the following periodic distributions nevertheless was viewed as part of a series of SEPPs. These conclusions reflect the Service's willingness to look beyond a strict reading of the Code, the legislative history, and Rev. Rul. 2002-62 in applying the SEPP Exception and the Recapture Rule.

END NOTES

1. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").
2. 2002-42 I.R.B. 710, *modifying* Q&A-12 of Notice 89-25, 1989-1 I.R.B. 68.
3. It should be noted that a private letter ruling (or "PLR") may not be used or cited as precedent, and may be relied on only by the taxpayer to whom it is issued. *See* sections 6110(k)(3) and 6110(b)(1)(A).
4. For this purpose, the term "qualified retirement plan" is defined in section 4974(c) to include (1) a qualified plan under section 401(a); (2) an annuity plan described in section 403(a); (3) a section 403(b) annuity contract; (4) an IRA account under section 408(a); and (5) an IRA annuity described in section 408(b).
5. Form 1099-R (*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.)* is used to report distributions from profit-sharing or retirement plans, IRAs, annuities, pensions, insurance contracts and certain other instruments. The 2011 Instructions for Forms 1099-R and 5498 provide that distribution code 1 (Early distribution, no known exception) must be input into box 7 of a Form 1099-R that reports a distribution made before the employee/taxpayer attains age 59½ if the payor cannot determine whether an exception to the 10 percent penalty tax applies with respect to the distribution. Distribution code 2 (Early distribution, exception applies) must be input into box 7 of a Form 1099-R that reports a distribution made before the employee/taxpayer attains age 59½ if it can be determined that an exception to the 10 percent penalty tax applies with respect to the distribution. Consistent with the Recapture Rule, the instructions explain that even if the employee/taxpayer has attained age 59½, distribution code 2 should be used if a series of SEPPs is modified within five years of the first payment (within the meaning of section 72(q)(3) or (t)(4)) where distributions in previous years were reported using distribution code 2.
6. S. Rep. No. 99-313, at 615 (1986); Staff of the J. Comm. On Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 717 (J. Comm. Print 1987).
7. Staff of the J. Comm. On Tax'n, 97th Cong., General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, at 364 (J. Comm. Print 1982). *See also* PLR 200818018 (Jan. 29, 2008) (finding that variable payments determined under a method that was actuarially equivalent to the method of withdrawing a constant number of annuity units described in the TEFRA Blue Book produced a series of SEPPs within the meaning of section 72(u)(4)(C)).
8. H. R. Rep. No. 99-841 (Vol. II), at II-457 (1986). *See also* H. R. Rep. No. 99-841 at II-403 (providing the same explanation with respect to the SEPP Exception under section 72(q)(2)(D)).
9. *See, e.g.,* PLR 200929021 (Apr. 21, 2009).
10. *See* PLR 200616046 (Jan. 27, 2006) (concluding that SEPPs from an IRA were not modified where they continued after what appears to be a complete trustee-to-trustee transfer to another IRA, but which was described as a "roll over" of the IRA funds "in their entirety").
11. *See, e.g.,* PLR 200929021; PLR 200616046.
12. PLR 200628029 (Apr. 17, 2006).
13. 132 TC 330 (2009).
14. The court noted that the exceptions to the 10 percent penalty tax under section 72(t)(2)(B) (relating to distributions for medical expenses), and section 72(t)(2)(f) (relating to distributions for first home purchases) include similar provisions. Id. at 335.
15. *Id.*
16. *Id.*
17. *See,* e.g., PLR 201030038 (May 5, 2010); PLR 200717026 (Feb. 1, 2007).
18. *See, e.g.,* PLR 200930053 (Apr. 27, 2009); PLR 200840054 (July 8, 2008); PLR 200835033 (June 3, 2008); PLR 200503036 (Oct. 25, 2004).
19. *Id.*
20. *See, e.g.,* PLR 9146008 (Aug. 8, 1991) (concluding that in order for systematic withdrawals from a non-qualified annuity contract to qualify as distributions that are part of a series of SEPPs under the section 72(q)(2)(D) SEPP Exception, the withdrawals must be received as part of a "scheduled" series of substantially equal periodic payments over a duration not less than the life expectancy of the taxpayer).

NEW DEVELOPMENTS FOR LIFE/NONLIFE CONSOLIDATED RETURNS AND THE DISPROPORTIONATE ASSET ACQUISITION RULES

By Lori J. Jones

The Internal Revenue Service (IRS) recently issued three private letter rulings (PLRs) dealing with the application of the disproportionate asset acquisition rules under the life/nonlife regulations. As described in detail in this article, the PLRs reach conclusions generally favorable to the filing of life/nonlife consolidated returns and address certain issues not specifically addressed in the regulations. For example, the PLRs shed some light on what types of transactions might give rise to special acquisitions and, specifically, how the amount of premiums or reserves attributable to special acquisitions should be measured with respect to reinsurance contracts that are later modified in the ordinary course of business.

BACKGROUND

Treas. Reg. § 1.1502-47 contains rules that must be satisfied in order for a life insurance company to be an eligible corporation includible in a life/nonlife consolidated return. (By contrast, an ineligible nonlife company can be included in the life/nonlife consolidated return, but its net operating losses may not be used to absorb affiliated life insurance company taxable income.) Under the general rule, to be included in the life/nonlife consolidated return, a life insurance company: (i) must have been a member of the affiliated group for five taxable years prior to the time it can join in a life/nonlife consolidated return ("base period"); (ii) must have been engaged in the active conduct of a trade or business during the base period; (iii) must not have experienced a "change in tax character" during the base period; and (iv) must not have experienced a "disproportionate asset acquisition" during the base period. Treas. Reg. § 1.1502-47(d)(12)(i). If a life insurance company does not satisfy these tests, it can be included in the life/nonlife consolidated return only if the "tacking rules" of Treas. Reg. § 1.1502-47(d)(12)(v) are satisfied so that the base period of the "old corporation" is included in (or "tacks" onto) the calculation of the base period for a "new corporation."

The tacking rules generally require that at least 80 percent of the new corporation's assets acquired outside the ordinary course of business result from transfers qualifying under section 351 or 381 of the Internal Revenue Code from the old corporation. The old corporation must have the same tax character as the new corporation and the new corporation must not undergo a disproportionate asset acquisition at the end of the taxable year during which the first condition (the 80 percent test) is met. In addition, if the tacking rules are satisfied but the corporation undergoes a disproportionate asset acquisition, it will become ineligible at that time.

Whether the general rules or the tacking rules apply, a disproportionate asset acquisition can preclude life/nonlife consolidation. The tax policy underlying the disproportionate asset acquisition rules is that a corporation should not be considered to be the same company during the five-year waiting period for life/nonlife consolidation if its insurance business has fundamentally changed during the five-year period from outside asset acquisitions. Treas. Reg. § 1.1502-47(d)(12)(viii) states that in order to be eligible a corporation must not undergo during the base period a disproportionate asset acquisition which is attributable to an acquisition (or series of acquisitions) of assets from outside the group in transactions not conducted in the ordinary course of business (which are referred to as "special acquisitions"). Whether an acquisition results in a disproportionate asset acquisition depends on all the facts and circumstances including the following factors and rules:

(i) The portion of the insurance reserves at the end of the base period attributable to special acquisitions;
(ii) The portion of the fair market value of the assets (without reduction for liabilities) at the end of the base period attributable to special acquisitions;
(iii) The portion of the premiums generated during the last taxable year of the base period attributable to special acquisitions;
(iv) Money or other property contributed to a corporation by a shareholder that is not a member of the group is not a special acquisition; and

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(v) If a new corporation has relied on the tacking rules to become an eligible member of the life/nonlife consolidated group, it will become an ineligible corporation if it experiences a disproportionate asset acquisition during a consolidated taxable year.

For this purpose, a corporation will not experience a disproportionate asset acquisition unless 75 percent of one factor (whether or not listed above) is attributable to special acquisitions. Treas. Reg. § 1.1502-47(d)(12)(viii)(D). Therefore, the measurement of the respective reserves, assets and premiums attributable to the special acquisition is essential in order to determine whether the 75-percent threshold is met or exceeded.

RECENT PRIVATE LETTER RULINGS

The three recent PLRs address the disproportionate asset acquisition rules in connection with several different proposals to restructure holdings of U.S. subsidiaries by a foreign parent.[1] All of the PLRs appear to be supplemental to PLR 200644021 (July 28, 2006), which also included numerous rulings on the disproportionate asset acquisition rules.[2] (PLRs 200906006 (Oct. 17, 2008) and 201006002 (Nov. 6, 2009) both refer to the 2006 PLR and PLR 201047019 (Aug. 17, 2010) refers to PLR 200906006.)

Among other things, PLR 200906006 ruled on the proposed mergers of Lifeco 2 and 3 (members of the U.S. Parent 2 Group) into Lifeco 1 (member of the U.S. Parent 1 Group) (referred to as Lifeco 1 Transaction). PLR 200906006 contained a taxpayer representation that the transfer of assets in the Lifeco 1 Transaction was a special acquisition. Presumably, this representation confirms that the taxpayer concluded that the mergers of Lifeco 2 and 3 into Lifeco 1 were transactions from outside the group not in the ordinary course of business (and, thus, a special acquisition). (However, while the PLR contained rulings interpreting the regulations, it did not specifically conclude that the Lifeco 1 Transaction did not result in a disproportionate asset acquisition.) The notable rulings of the various PLRs are described below.

Base Period

In general, the regulations require the testing for disproportionate asset acquisitions at the end of the base period, *i.e.,* generally defined as the common parent's five taxable years immediately preceding the group's taxable year for which the consolidated return and determination of eligibility are made. *See* Treas. Reg. § 1.1502-47(d)(12)(ii). Therefore, the base period is a rolling five taxable year test. On this point, the IRS has ruled that determinations of disproportionate asset acquisitions are made by taking into account only those factors that are attributable to special acquisitions occurring during the relevant base period.[3]

In PLR 201047019, the taxpayer was concerned about how the volatility in the financial markets might affect the insurance reserves, assets and premiums of Lifeco 1's business and whether it might cause Lifeco 1 to undergo a disproportionate asset acquisition within the base period that included the mergers of Lifeco 2 and 3 into Lifeco 1. (Presumably, the taxpayer believed that there would not have been a disproportionate asset acquisition if such determination were to be made immediately after the mergers on the basis of the rulings in PLR 200906006.) It was further represented that Lifeco 1 had no intention to undertake any other special acquisitions in the foreseeable future and that any reinsurance transactions with related persons either have satisfied (or will satisfy in the future) the arm's-length standard of section 482. Based on the representations, the IRS concluded that the transfer of assets and liabilities from Lifeco 2 and 3 into Lifeco 1 will not constitute disproportionate asset acquisitions for ***any*** base period that includes the mergers. Therefore, the mergers in the PLR were taken into account only once at the end of the year which included the transaction. This appears to be a taxpayer-friendly reading of the regulations which arguably require the testing to be done at the end of ***every*** base period which included the mergers.

Measurement of Reserves Attributable to Special Acquisitions

The first factor listed in the regulations in determining disproportionate asset acquisitions is the portion of the insurance reserves the acquiring company holds at the end of the base period attributable to special acquisitions. As noted earlier, the threshold question is whether the reserves attributable to special acquisitions account for 75 percent or more of the acquiring company's total reserves (as defined in section 816(c)).[4]

PLR 200906006 also provides guidance on issues relating to reinsurance treaties. It holds in ruling (3) that if any insurance agreement, including any reinsurance treaty, to which Lifeco 2 or 3 is a party is assumed by Lifeco 1 in the Lifeco 1 Transaction, and, in the ordinary course of Lifeco 1's business, is later amended or modified by Lifeco 1 to permit the reinsurance of additional insurance contracts, the amount of insurance reserves and premiums attributable to these additional insurance contracts shall not be treated as premiums or

reserves acquired in a special acquisition. The IRS arguably could have taken the position that any modifications also were special acquisitions so this ruling also appears taxpayer-favorable. Ruling (2) provides that the amount of the life insurance reserves and premiums of Lifeco 1 attributable to the special acquisitions related to the Lifeco 1 Transaction will be determined by reference to the insurance reserves and premiums attributable to the insurance agreements, including any reinsurance treaties, that have been entered into by Lifeco 2 and 3 at the time of the Lifeco 1 Transaction, that are in effect at the time of the Lifeco 1 Transaction and that continue in effect during the relevant measurement period or that continue to be in effect at the relevant measurement date. While also taxpayer-friendly, this approach appears to require the taxpayer to determine the premium and reserves allocable to the reinsurance agreement and then separately to the modified portion of the agreement.

Measurement of Assets Attributable to Special Acquisitions

Another factor is the portion of the fair market value of the gross assets of the acquiring company at the end of the base period that is attributable to special acquisitions. In PLR 200906006, ruling (4) provides that the amount of assets attributable to special acquisitions of Lifeco 1 will be determined by reference to all of the assets held by Lifeco 2 and 3 at the time of the Lifeco 1 Transaction, transferred to Lifeco 1 in that Transaction, and held by Lifeco 1 during the relevant measurement period or on the relevant measurement date. It further provides (i) that where Lifeco 1 acquires an asset following the Lifeco 1 Transaction other than in the ordinary course of business, and (ii) that asset acquisition is attributable to, or otherwise related to, a disposition of an asset previously held by Lifeco 2 or 3 at the time of the Lifeco 1 Transaction, the newly acquired asset will be considered an asset previously held by Lifeco 2 or 3 to the extent of the relinquished asset's value at the time of disposal of that asset. This also appears to be a favorable ruling for the taxpayer because it does not treat the new acquisitions as special acquisitions even though the assets are purchased outside the ordinary course of business. However, the rule will require the potentially burdensome tracing of the asset values.

Measurement of Premiums Attributable to Special Acquisitions

The last factor that must be measured in terms of the 75-percent test relates to premiums generated during the last taxable year of the base period attributable to special acquisitions. In this case, Treas. Reg. § 1.1502-47(d)(12)(viii)(D) specifically identifies the last taxable year of the base period. Ruling (6) of PLR 200906006 states that the term "last taxable year of the base period" means the taxable year immediately preceding the group's taxable year for which the consolidated return and determination of eligibility is made. In both PLR 200906006 and PLR 201006002, the IRS ruled that the term "premiums" used in connection with any insurance agreement, including any reinsurance treaty, means (i) the "'gross amount of premiums and other consideration,' as defined in section 803(b)(1), including any negative modco reserve adjustment, less (ii) the sum of (a) any return premiums, including any experience refunds, positive modco reserve adjustment, and other policyholder dividend or reimbursement of any policyholder dividend (in each case attributable to an indemnity reinsurance agreement) and (b) any consideration payable pursuant to any indemnity reinsurance agreement." *See* PLR 200906006 (ruling 5); PLR 201006002 (ruling 14). Rulings (2) and (3) of PLR 200906006 described earlier in this article apply to both reserves and premiums.

However, in PLR 201047019 (ruling 2), the IRS appears to modify the definition of premiums and eliminate (or at least reduce) the reduction of premium by any consideration payable in an indemnity reinsurance transaction. That is, after ruling that the mergers of Lifeco 2 and 3 into Lifeco 1 will not constitute a disproportionate asset acquisition for ***any*** base period (to address the volatility issue discussed earlier), it then states that the premiums that Lifeco 1 must take into account will *not be* reduced by any arm's-length premiums that Lifeco 1 pays to a reinsurer as the initial consideration for the reinsurer entering into an indemnity reinsurance transaction with Lifeco 1. This appears inconsistent with the previous PLR and the definition of premiums under section 803.

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In PLR 201006002, the transactions in question generally involved reinsurance transactions rather than mergers. In that case, the IRS applied section 351 to the transfer of assets pursuant to an assumption reinsurance transaction, but apparently viewed the indemnity reinsurance and co-modco reinsurance transactions as taxable transactions. As stated above, ruling (14) contained a general definition of premiums. Ruling (15) states that the reference to premiums generated during the last taxable year of the base period which are attributable to special acquisitions will not include the premiums that each company receives as consideration for entering into the indemnity coinsurance transaction and the co-modco transaction. This also appears to be a favorable ruling for the taxpayer presumably on the basis that the taxable reinsurance transactions are not special acquisitions.

CONCLUSION

In summary, the PLRs indicate that the IRS is willing to entertain ruling requests and, in some cases, be flexible in their approach to the disproportionate asset acquisition provisions in the life/nonlife regulations.

END NOTES

1. In unrelated PLR 200905020 (Oct. 21, 2008), the IRS also addressed the eligibility rules and concluded that the subsidiary would be treated as having engaged in the active conduct of a trade or business throughout every day of the base period despite the fact that it no longer issued new policies and was in run-off.
2. PLR 201006002 is described in more detail in, *The Mystery of PLR 201006002, 6 TAXING TIMES 41*, Vol. 6. Issue 3 (Sept. 2010).
3. *See* PLR 200906006, ruling (8). This last ruling also was included in PLR 200644021.
4. Even though the regulations refer to total reserves in section 801(c), the proper current reference is to the definition of total reserves in section 816(c) as was confirmed in ruling (7) of PLR 200906006.

NEW PLR ADDRESSES TAIL-DESIGN LTC-ANNUITY RIDER

By Bryan W. Keene and Eric G. Lanning[1]

On Feb. 4, 2011, the Internal Revenue Service (IRS) released PLR 201105001, which addresses the federal income tax treatment of a tail-design long-term care ("LTC") insurance rider to a deferred annuity contract. A tail design generally means that all LTC benefits that are payable during an initial period are offset completely by reductions to the annuity contract's cash value. If and when those benefits are exhausted, LTC benefits continue for a subsequent period without affecting the cash value. Thus, net amount at risk ("NAR") is payable only during the tail end of the benefit stream. The new ruling addresses whether the taxpayer's particular tail design exhibits sufficient risk shifting and risk distribution to be treated as an "insurance contract," and thus as a qualified long-term care insurance ("QLTCI") contract, for purposes of section 7702B.[2]

FACTS OF THE RULING

The taxpayer in the ruling proposes to offer a QLTCI rider (the "Rider") with certain deferred annuity contracts it plans to issue to a large number of insureds (the "Contracts"). Some of the Contracts are fixed contracts and others are variable. Different versions of the Rider will be available depending on the Contract type, but each Rider will operate in essentially the same way.

Subject to certain waiting periods and a deductible, LTC benefits will become payable under the Rider if the insured is a chronically ill individual who is receiving qualified long-term care services.[3] The LTC benefits will be payable throughout two successive periods—Phase 1 (the self-funding period) and Phase 2 (the NAR period). Together, the two phases are scheduled to last 72 months. Phase 1 will be scheduled for either 24 or 36 months, while Phase 2 will be scheduled for either 48 or 36 months, as necessary for the two phases to total 72 months. The actual length of each phase could be longer than scheduled, depending on the LTC benefits actually paid.

The LTC benefits during each phase are subject to two types of caps: a monthly benefit cap and an aggregate or total benefit cap. The total benefit cap during Phase 1 is determined by reference to the Contract's cash value. The monthly benefit cap is generally determined by dividing the total benefit cap by Phase 1's scheduled duration. For example, if Phase 1 was scheduled to last 24 months and the Contract had a $50,000 cash value, the total benefit cap during Phase 1 would be $50,000 and the monthly benefit cap during Phase 1 would be about $2,083 ($50,000 divided by 24 months).

During Phase 2, the total dollar cap on LTC benefits is determined by reference to Phase 1. Specifically, if the two phases are scheduled for equal durations, the total benefit cap will be the same for each phase. If Phase 2 is scheduled to last twice as long as Phase 1, the Phase 2 total benefit cap will be twice that of Phase 1.

The monthly benefit cap remains the same, in essence, throughout both phases; however, the available monthly benefit may be reduced below the cap amount. If the insured is receiving qualified long-term care services in a nursing home or as a part of hospice care, LTC benefits equal to the full monthly dollar cap are available. If, however, the insured is receiving qualified long-term care services outside of a nursing home or hospice care, the available monthly benefit is cut in half. This has no effect on the total benefit caps under the Rider. Rather, the effect of a reduced monthly dollar cap is that the actual length of Phase 1 or Phase 2 could be longer than scheduled, because the same aggregate LTC benefits would be paid out more slowly. Phase 1 ends, and Phase 2 begins, when the total LTC benefits paid equal the total dollar cap on Phase 1 benefits. Likewise, Phase 2 ends when the Phase 2 total benefit cap is exhausted by the payment of monthly LTC benefits.

Some versions of the Rider also provide for certain LTC benefits in excess of the foregoing dollar caps. The ruling refers to such additional benefits as "Augmented Payments." The mechanics for calculating the Augmented Payments differ somewhat depending on whether the Contract is a fixed or variable annuity. In general, however, they are determined on each Rider anniversary based on increases in the Contract's

CONTINUED ON **PAGE 20**

cash value relative to the cash value that was used in determining the total benefit cap for Phase 1. Thus, continuing the foregoing example, if the Contract's cash value on a Rider anniversary had increased from $50,000 to $75,000, there would be $25,000 in Augmented Payments available under the Rider. These additional benefits would be payable in equal monthly installments over the remaining scheduled durations of Phase 1 and Phase 2, subject to the same 50 percent limitation described above for non-nursing home and non-hospice care. The Rider includes an ordering rule under which Augmented Payments are available in a month only if all other LTC benefits have been exhausted for that month.

If the insured is not chronically ill on the Contract's maturity date, the Phase 2 benefits will remain payable as paid-up insurance, but all other Rider benefits will expire.

LTC benefits paid under the Rider will have different effects on the Contract's cash value depending on the type of benefit and when it is paid. In general, all LTC benefits paid during Phase 1—whether the base benefits or Augmented Payments described above—will reduce the Contract's cash value dollar-for-dollar. Augmented Payments made during Phase 2 also will reduce the Contract's cash value dollar-for-dollar. All other LTC benefits paid during Phase 2, however, will have no effect on the Contract's cash value. Rather, such LTC benefits will be comprised entirely of NAR that the issuing life insurance company pays from a reserve or its own surplus.

If the insured is receiving LTC benefits under the Rider when the Contract reaches its scheduled maturity date (when annuity payments otherwise would be required to begin), the Rider benefits will continue and annuitization will be delayed until the insured recovers or the LTC benefits are exhausted. If the insured is not chronically ill on the Contract's maturity date, the Phase 2 benefits will remain payable as paid-up insurance, but all other Rider benefits will expire.

ANALYSIS AND CONCLUSION

The taxpayer in PLR 201105001 requested a ruling that the Rider constitutes an "insurance contract" for purposes of section 7702B(b)(1). Under that provision, a QLTCI contract is defined as an "insurance contract" that meets certain requirements. Thus, by addressing whether the Rider is an insurance contract, the ruling effectively addresses whether the Rider is a QLTCI contract, assuming that all other requirements of section 7702B are met.

The IRS notes in the ruling that neither the Internal Revenue Code (the "Code") nor the regulations under the Code define "insurance" or "insurance contract." The ruling observes, however, that in *Helvering v. Le Gierse*,[4] the Supreme Court held that an arrangement must exhibit both risk shifting and risk distribution in order to constitute insurance for federal income tax purposes. The ruling also discusses various criteria identified in other judicial decisions and IRS rulings as necessary for an insurance characterization, including that (1) the risk transferred must be a risk of economic loss and not merely an investment or business risk,[5] (2) the risk must contemplate the fortuitous occurrence of a stated contingency,[6] and (3) the arrangement must constitute insurance in the commonly accepted sense.[7]

With regard to risk shifting, the ruling states that it occurs "if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer." With regard to risk distribution, the ruling states that it incorporates the phenomenon of the law of large numbers, and that "by assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums."[8] Finally, the ruling states that the "commonly accepted sense" of insurance derives from all the facts and circumstances of a particular case, with emphasis on how the arrangement compares to others that are known to constitute insurance.

Based on the foregoing, the ruling concludes that the Rider is an insurance contract for purposes of section 7702B(b)(1). In reaching this conclusion, the IRS focused particularly on the risk shifting requirement from *Le Gierse.* The IRS framed that issue as whether there is any possibility that any particular insured could incur a loss that the Rider would reimburse. In that regard, the ruling states that if the Rider were structured so that benefits would always be offset by the Contract's cash value, then the Rider could not constitute insurance because there would never be a reasonable possibility that the Rider would reimburse an economic loss incurred by the insured person. The IRS concluded, however, that this was not the case with

respect to the Rider. Rather, the IRS found that the taxpayer life insurance company had assumed the risk under the Rider that the insured would become eligible for LTC benefits in excess of those offset by the Contract's cash value.

The IRS also concluded that the risk of chronic illness is a morbidity risk that can give rise to economic loss, that the taxpayer would distribute that risk of loss across a large number of insureds and therefore satisfy the risk distribution element of *Le Gierse*, and that the Rider constitutes insurance in the commonly accepted sense. As a result, the ruling concludes that the Rider is an insurance contract.

FINAL OBSERVATIONS

The new ruling is the first to address the federal income tax treatment of an LTC-annuity rider that follows a tail design. In 2009, the IRS issued a private letter ruling addressing the risk shifting characteristics of a coinsurance or *pro rata* design, where each LTC benefit was offset only partially by reductions in the annuity contract's cash value, with the remaining portion of each benefit payment being comprised of NAR.[9] The new ruling confirms that not every benefit payment needs to include NAR, and that a tail design also can qualify as insurance for purposes of section 7702B(b)(1) —as was the case under the facts presented in the ruling. The ruling reflects the fact that the Pension Protection Act of 2006,[10] which authorized LTC-annuity products, provides considerable flexibility for insurers in designing such products, so that they may best address consumers' needs for affordable LTC insurance coverage.

END NOTES

1 The authors would like to thank John Adney and Craig Springfield, both of Davis & Harman LLP, for their helpful comments on this article.
2 Each reference to a "section" is to a section of the Internal Revenue Code of 1986, as amended.
3 See section 7702B(c)(1) and (2) for the definition of qualified long-term care services and chronically ill individual, respectively.
4 312 U.S. 531 (1941).
5 *See* Allied Fidelity Corp. v. Comm'r, 572 F.2d 1190, 1193 (7th Cir. 1978); Le Gierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C.B. 127.
6 *See* Comm'r v. Treganowan, 183 F.2d 288, 290-92 (2d Cir. 1950).
7 *See, e.g.*, Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 (Fed. Cir. 1993); AMERCO, Inc., v. Comm'r, 979 F.2d 162 (9th Cir. 1992), *aff'g* 96 T.C. 18 (1991).
8 *See* Clougherty Packing Co. v. Comm'r, 811 F.2d 1297, 1300 (9th Cir. 1987).
9 PLR 200919011 (Feb. 2, 2009).
10 P.L. 109-280.

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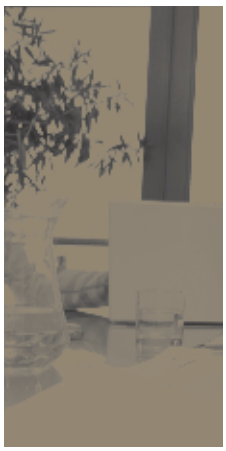

IASB EXPOSURE DRAFT ON INSURANCE CONTRACTS

By Frederic J. Gelfond and Yvonne S. Fujimoto

In July 2010, the International Accounting Standards Board (IASB) released Exposure Draft ED/2010/8 *Insurance Contracts* (ED), which, if adopted, would replace IFRS 4, *Insurance Contracts* and would significantly change the manner in which insurers account for insurance contracts in their financial statements. From a U.S. federal income tax perspective, the most significant impact of this, if any, is not likely to arise from the manner in which the ED proposes to measure income. Rather, because it provides a "global" view on what should be accounted for as an insurance contract, the ED might ultimately prove to be most meaningful as another form of authoritative standard to look to in determining what types of arrangements should be deemed to qualify as insurance contracts for income tax purposes.

The following provides a brief background on the IASB insurance contract project and an overview of the major components of the proposed new accounting standard, including the guidance it provides regarding how to define the term "insurance contract."

BACKGROUND

In 1997 the International Accounting Standards Committee, the predecessor to the IASB, established a steering committee to commence an examination of accounting standards for insurance contracts. Underlying the initiative to address the accounting treatment for insurance contracts have been concerns that current accounting practices (1) do not provide sufficient clarity regarding the economics of insurance contracts, and (2) have led to a lack of comparability among insurers and with other financial institutions. The latter is viewed to have been exacerbated by the variety of different accounting models that exist today. Hence, the overall objective of the IASB is to develop a standard that provides a consistent basis for accounting for insurance contracts; one that will make it easier for users of financial statements to understand how insurance contracts affect an insurer's financial position, financial performance and cash flows, and that also enhances the comparability of financial statements across entities, jurisdictions and capital markets.

In 2002, the IASB began a two-phase project, with Phase I culminating in 2004 with the release of International Financial Reporting Standard (IFRS) 4, *Insurance Contracts*. Because IFRS 4 was intended to be temporary, it made only limited adjustments to the accounting for insurance contracts, and permitted a variety of practices to continue, in an effort to avoid making major changes that might be subject to reversal upon the completion of the second phase of the project.

The Financial Accounting Standards Board (FASB) joined the project in October 2008. Since then, the landscape of Phase II has been rapidly evolving into a key convergence project. Discussions leading to the ED were held jointly by the IASB and the FASB and resulted in the FASB publishing the IASB's ED as the Discussion Paper, *Preliminary Views on Insurance Contracts,* (DP) in September 2010 rather than issuing its own exposure draft. The DP seeks the views of U.S. constituents on the proposed IFRS model, and to gather more information as to whether the possible new guidance provides sufficient improvement to U.S. GAAP to justify issuing new guidance.

The proposed accounting standard is intended to apply to all insurance, including reinsurance contracts—life and nonlife—that meet the definition of insurance contract set forth in the current IFRS 4. As discussed below, that definition is based on whether an arrangement involves the transfer of significant insurance risk. In addition, the proposed new accounting standard provides for a measurement model intended to focus on (1) the drivers of insurance contract profitability and current estimates of cash flows, (2) presentation of information about contracts that reflect changes in those drivers, (3) consistency in accounting for embedded options and guarantees in insurance contracts and the unbundling, in general, of items that are not closely related to the insurance coverage, (4) usage of consistent financial market inputs, such as interest rates, and (5) a framework for dealing with more complex insurance contracts, including those that are yet to be developed.

While the IASB and FASB reached common ground on many areas, there are some areas in which they reached different conclusions. The primary area of tension between the IASB and

FASB relates to the proposal in the ED for insurance liabilities to be measured on a current value basis with maximum use of market consistent inputs. That is, the ED requires insurance liabilities to be measured using a transparent building blocks accounting model based on a discounted probability-weighted estimate of future cash flows. The accounting for the volatility inherent in this probability-weighted estimate is an area upon which the IASB and FASB failed to agree during their deliberations, and resulted in the IASB seeking feedback on two different methods.

The Proposed Measurement Model

More precisely, the ED proposes that all insurance contracts be accounted for by applying a measurement model that uses a transparent building block approach. The building blocks are:

1. a probability-weighted estimate of future cash flows,
2. a discount rate to reflect the time value of money, and
3. a margin to reflect uncertainty and future profit.

The first building block is defined as a current, unbiased and probability-weighted estimate of the projected future cash flows expected to arise as the insurer fulfills the obligation under the insurance contract, *i.e.,* an expected value. The contract period includes all cash flows until the point at which the insurer can unilaterally terminate or re-underwrite (reassess the risk of the particular policyholder and re-price it to reflect fully the risk of) the contract. This is known as the contract boundary and it represents an important and innovative feature of the proposal.

Under the proposal, the insurance contract is to be recognized initially at the earlier of the date when the insurer is bound by the terms of the insurance contract (usually the signing date) or when the insurer is first exposed to risk under the contract (the effective date of the contract); it is derecognized when it no longer qualifies as a liability of the insurer.

The process to estimate the future cash flows is not based on fair value concepts; instead it is to reflect the insurer's own perspective and cover all future cash flows that are integral to the fulfillment of the insurance contract on an expected value basis (*i.e.,* probability-weighted). These cash flows would include premiums, expenses, benefits and claims payments, as well as incremental acquisition costs, and in the case of participating insurance contracts, the benefits that an insurer expects to pay to policyholders (*i.e.,* policyholder dividends). Observable market data (for example, interest rates and other market data) are to be considered in developing the estimates.

This method is referred to as the "current fulfillment value" approach because it focuses on the entity's fulfillment obligations.

The second building block involves discounting of the cash flows using the discount rate that reflects the characteristics of the insurance liability—*i.e.,* its currency, duration and liquidity characteristics. The ED establishes that the discount rate is not to reflect the characteristics of the assets backing the liability, unless the amount, timing or uncertainty of the contract's cash flows depends on the performance of specific assets (*e.g.,* participating contracts). The discount rate could be estimated using a risk-free rate adjusted for an illiquidity premium. For example, a payout of a traditional immediate annuity results in highly illiquid cash flows because the policyholder cannot withdraw cash before each annuity payment becomes due or redeem the contract at will.

That is, the ED requires insurance liabilities to be measured using a transparent building blocks accounting model based on a discounted probability-weighted estimate of future cash flows.

The above-noted difference between the IASB and FASB approaches involves the third building block,[1] the margin to reflect uncertainty and future profits. As a result of the IASB's and FASB's failure to agree on the accounting for the volatility inherent in the estimate, two different methods are discussed in the ED:

- The first method—reflective of the IASB approach—requires the uncertainty of the cash flows to be explicitly measured in a risk adjustment that insurers would calculate using one of three permitted techniques. Any accounting profit that would arise when the insurance contract is measured as the sum of the expected value and the risk adjustment is captured through a residual margin and recognized over the period of the insurance coverage.

- The alternative method prescribed by FASB avoids the explicit measurement of estimation uncertainty (*i.e.,* the risk adjustment) and, instead, captures it together with any future profit in a "composite margin" that is subsequently released to profit using a formula based on the actual cash flows paid and received compared to their expected value.

CONTINUED ON **PAGE 24**

While the above measurement model is the centerpiece of the ED, the proposed guidance covers a number of other detailed issues, full analysis of which is substantially beyond the scope of this *Taxing Times* piece. Briefly, however, among the other issues it deals with are the following:

- A simplified approach for short-term contracts that provides a shortcut method during the "pre-claim" phase for contracts with a coverage period of 12 months or less.
- Contract boundary concepts that require consideration of a contract as a single bundle of rights and obligations, thus avoiding mismatches that can occur by considering such items separately.
- Treatment of participating features as being so interdependent with the other clauses of the contract that they should be treated as a component of the contract and thus be included in the estimation of the future cash flows that the insurer will pay to its policyholders.
- The unbundling of contract components that are not closely related to the insurance coverage.
- A presentation approach that requires display on the face of the statement of comprehensive income of the key components of the building blocks model that underpin profit recognition.
- Disclosures that are more descriptive and prescriptive than IFRS 4.
- Guidelines on the treatment of reinsurance.

DEFINITION OF INSURANCE CONTRACT . . . THE REAL TAX IMPACT?

While the issuance of the ED by the IASB may be an important accounting development, the question that remains for U.S. tax professionals is: "What does the ED mean for tax purposes?" That is, in the United States, the taxation of insurance companies is based on statutory accounting, not GAAP or IFRS. As such, it appears that adoption of IFRS 4 would have a limited, or possibly no, impact on the ultimate determination of taxable income by a U.S. insurance company under current tax rules.

One circumstance where it could have an impact would be if the company has taxable income flowing into it from a foreign branch operation that is required under local law to follow IFRS and use it as a basis for determining taxable income. IFRS 4 could also have a significant impact on the measurement of deferred tax assets and liabilities reported on GAAP/IFRS financial statements. This is the result of the fact that such amounts would be determined based on a comparison of tax bases to the new IFRS bases, and would also be subject to whatever recognition standards may apply.

As noted above, however, the ED may also be important from a tax perspective as it provides another standard one could look to in seeking to establish a tax definition of insurance contract. That is, the Internal Revenue Code[2] does not define the term "insurance." That task has been left, for the most part, to the courts, and has resulted in an evolving framework for determining the existence of insurance for federal income tax purposes. The Internal Revenue Service (IRS) has also provided its insights over the years as to what will qualify as insurance,[3] but, nevertheless, the definition of insurance continues to be a regular matter of controversy.

Although the IRS has never formally accepted an accounting definition of insurance as establishing the standard for governing the tax characterization of an arrangement, there are times when it has looked to the accounting standards as providing relevant guidance.[4] For example, it has looked to ASC 944-20-15-41 (formerly part of FAS 113) to determine the existence of an insurance risk based on a reasonable possibility of a significant loss by the insurer under an arrangement. The ED includes similar concepts in its definition, which is based on the transfer of significant insurance risk to the insurer.

The ED defines the term "insurance contract" as:

> A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

It further defines the term "insurance risk" to mean, "[r]isk, other than financial risk, transferred from the holder of a contract, to the issuer," and defines an insured event as, "[a]n uncertain future event that is covered by an insurance contract and creates insurance risk."

While each of these terms has resulted in a fair amount of discussion in the tax arena over the years, the ED provides a substantial amount of guidance on how to apply these terms, including what will be deemed to be an uncertain future event for IFRS accounting purposes. First it analogizes the terms "uncertainty" and "risk," and provides that "uncertainty (or risk) is the essence of an insurance contract." The ED then states that, "at least one of the following is uncertain at the inception of an insurance contract:

> (a) whether an insured event will occur;

(b) when it will occur; or
(c) how much the insurer will need to pay if it occurs."

It then explains that an insured event can be the discovery of a loss during the term of a contract, even if the loss occurred before the inception of the contract, while in other contracts, the insured event is an event that occurs during the term of the contract even if the loss is discovered after the contract terminates. The ED then elaborates that an insurance contract can cover events that have already occurred—and be known to have occurred—but whose financial effect is still uncertain. Under those contracts, it explains, the insured event is the discovery of the ultimate cost of those claims.

The above definition of insurance actually first appeared in IFRS 4 Phase I, which focused on the introduction of a workable definition of insurance contracts that is reflective of national accounting practices under IFRSs. This definition proved to be effective and, therefore, the ED introduced only two limited refinements.

The first introduces the requirement to use present values to assess whether insurance risk is significant. The second relates to the requirement that the scenarios considered in assessing whether the insurance risk is significant have commercial substance. To have commercial substance, the scenario must be capable of producing a loss for the insurer after considering all the inflows it may receive from the contract. Both of these clarifications have been added to facilitate the FASB's moving to adopt the IFRS's insurance contract definition.

Whether the IRS is able to apply this type of standard in determining whether an arrangement is an insurance contract remains to be seen. Nevertheless, the ED definition establishes a uniform basis upon which authorities around the world may conduct this analysis.

EFFECTIVE DATE

The ED was open for comments until Nov. 30, 2010, with an initial goal of issuing a final standard in June 2011 that has now been pushed back to December 2011. It is expected that the effective date would be aligned with the mandatory application of IFRS 9, *Financial Instruments* (currently Jan. 1, 2013). Consideration will be given to delaying the effective date of IFRS 9 if the IFRS on insurance contracts has a mandatory effective date later than Jan. 1, 2013.

CONCLUSION

The revisions to IFRS 4 reflected in the ED were significant, and it will be interesting to see what changes come about as a result of comments submitted to the IASB and FASB. From a tax perspective, it will be even more interesting to see if the ED, in either its current or final form as new IFRS 4, could have an impact on how the term "insurance contract" is looked at for federal income tax purposes.

END NOTES

1 Under the IASB approach, it is actually the third and fourth building blocks. As discussed in the text, the FASB approach uses a composite margin to capture both elements and, hence, involves only three building blocks.
2 Internal Revenue Code of 1986, as amended.
3 *See, e.g.,* Rev. Rul. 2007-47, 2007-2 C.B. 127, and Rev. Rul. 89-96, 1989-33 I.R.B. 9 involving insurance risk; Rev. Rul. 2002-89, 2002-52 I.R.B. 984, Rev. Rul. 2002-90, 2002-52 I.R.B. 985, and Rev. Rul. 2002-91, 2002-52 I.R.B. 991, and Rev. Rul. 2005-40, 2005-24 I.R.B. 4, discussing risk shifting and risk distribution.
4 *See, e.g.,* 1997 FSA 708.

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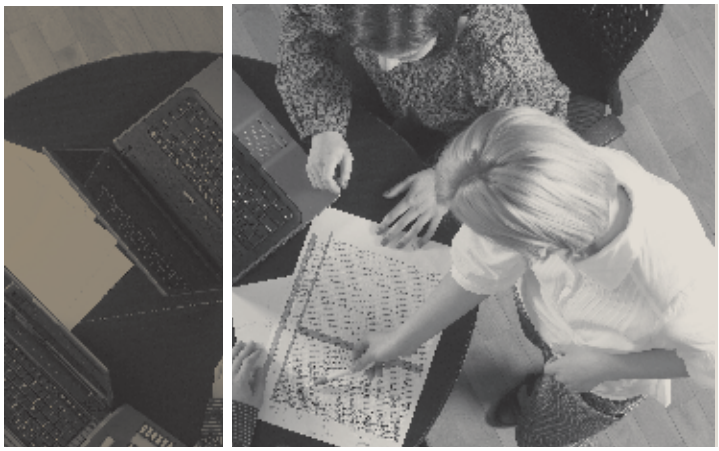

A CONVERSATION ABOUT IFRS

By Christian DesRochers, Peter H. Winslow and Craig Pichette

Editor's Note: *On June 30, 2010, the International Accounting Standards Board (IASB) released an Exposure Draft proposing a comprehensive accounting standard titled "Insurance Contracts." On Feb. 9, 2011, the Financial Accounting Standards Board (FASB) voted to work with the IASB to develop a single converged accounting standard for insurance contracts.*

This issue of Taxing Times *contains two articles related to the developing international accounting rules. In "IASB Exposure Draft on Insurance Contracts," Frederic Gelfond and Yvonne Fujimoto provide an overview of the Exposure Draft. The related article, "A Conversation about IFRS," provides a discussion of the potential tax policy implications of the emerging accounting standards.*

The Exposure Draft, which applies to all insurance contracts, identifies two models for the measurement of insurance liabilities: (1) an unearned premium approach for short duration (one-year) contracts and (2) a current fulfillment value approach for all other insurance contracts. The proposed measurement model uses four "building blocks" to measure an insurance liability:

- *Current estimates of future cash flows—probability weighted amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information.*
- *Time value of money—an adjustment that uses an interest rate to convert future cash flows into current amounts.*
- *Risk adjustment—an assessment of the uncertainty about the amount of future cash flows.*
- *Residual margin—contract profit (reported over the life of the contract). The residual margin is an amount that eliminates the recognition of a gain at the inception of a contract (i.e., the present value of future cash inflows is greater than the present value of future outflows, including the risk adjustment). A loss at issue would be immediately recognized under the proposed model.*

After observing that, while many nonlife insurance contracts provide only insurance coverage, others "blend together several types of cash flows arising from various components that would, if issued as free-standing contracts, be subject to a variety of accounting treatments,"[1] the Exposure Draft proposes to unbundle certain elements of the contracts. In the Exposure Draft, unbundling refers to the bifurcation of a contract into components, separating insurance elements from investment elements.

On Sept. 1, 2010, FASB issued a discussion paper on valuation of insurance contracts and proposed a building block approach similar to the IASB Exposure Draft, but with a composite margin instead of the risk adjustment plus residual margin. The NAIC has appointed a Commissioner-level group to consider the future direction of statutory accounting in the context of changing GAAP and international accounting standards.

The IFRS Exposure Draft prompted over 200 comments. Major issues raised in these comments included:

- *Treatment of short-duration contracts,*
- *Residual versus composite margin and remeasurement of residual margin,*
- *Volatility in profits or loss, and*
- *Unbundling.*

Many of these key issues have potential income tax implications.

While the basis for tax reporting in the United States continues to follow statutory accounting, the new international accounting standards are likely to have significant implications for all insurers in the foreseeable future, which include tax. Prior issues of Taxing Times *have featured interdisciplinary dialogues on selected tax issues related to the change in statutory reserves to a principle-based approach. In this issue, we turn to the topic of fundamental accounting changes proposed under international financial reporting standards (IFRS). To think about some potential tax policy issues relative to IFRS, I have invited two experts in the field, Peter Winslow*

of Scribner, Hall & Thompson, LLP and Craig Pichette of KPMG, to join me in what I hope will be a thought-provoking discussion of the issues. The opinions expressed in this dialogue are solely those of the participants.

ACCOUNTANT, ACTUARY AND ATTORNEY DIALOGUE: A CONVERSATION ABOUT IFRS

Chris: The current life insurance tax model, which has been in place since 1984, can be characterized as a modified income model, which is based on statutory annual statement accounting modified for tax, including adjustments for tax reserves and deferred acquisition costs (DAC). However, in the past, different approaches have been used to tax life insurers, including the so-called three-phase system under the 1959 Act, and the free investment income tax base under the 1921 Revenue Act.

Most observers in both industry and government would generally agree that the 1984 Act has worked well over time. However, the increasing sophistication of insurance products, as well as the developments in both statutory, U.S. GAAP and IFRS accounting, have made it more difficult to reconcile various systems of book and tax accounting. For example, a key difference in the Exposure Draft method from the current tax system is that premiums are revenue for tax, which necessitates a reserve deduction, while the Exposure Draft method can be characterized as a "margins" approach to income. This leads to the question of whether the current modified statutory income approach is becoming obsolete and inevitably must be replaced, much the same way as the 1959 Act finally gave way to the 1984 Act. Peter, what do you think?

Peter: There are many pressures that already are testing the limits of the 1984 Act, including innovation in product development and the trend toward principle-based reserves (PBR). Up to this point, the 1984 Act has stood up relatively well to the challenges of product development; much better, in fact, than the 1959 Act did. This is because the drafters of the 1984 Act had the wisdom to foresee that new products would be developed and changes in reserve standards could occur. The 1984 Act drafters created dynamic tax reserve rules that adjust automatically when the NAIC or 26 states adopt new reserving standards. What the 1984 Act drafters did not foresee was that life insurance accounting standards could change more radically from a deterministic reserving regime to a principle-based approach.

Chris, getting back to your question, I would say that, if the NAIC were to adopt some version of the proposed IFRS Exposure Draft, almost certainly changes to the 1984 Act would be necessary. Although in theory the current Internal Revenue Code ("Code") provisions could continue to operate, the uncertainty in how they would apply precisely to particular products seemingly would be too great for the Internal Revenue Service (IRS) and industry to tolerate, and a tax law change would likely be inevitable. The more difficult question is whether the 1984 Act would have to change if the NAIC declines to adopt IFRS, and retains some version of the current statutory income approach—say principle-based reserves with a net premium reserve floor. In such a situation, the 1984 Act could continue to operate. The question then becomes: would the adoption of IFRS by the SEC create so much political pressure that an overhaul of the 1984 Act would be triggered? Any thoughts on this more difficult question, Craig?

Craig: I agree that adoption by the NAIC of an accounting model or reserve methodology as radically different from the current statutory and tax accounting model as the Exposure Draft may necessitate a legislative change. This is just a guess, but I do not believe that adoption of an accounting model like that in the IFRS or GAAP Exposure and Discussion Drafts would necessarily trigger tax legislation. We already have a tax accounting model based upon statutory accounting that recognizes income independently relative to the GAAP accounting model. The congressional reaction to these differences between statutory accounting and GAAP has basically been to put in place piecemeal solutions like DAC capitalization under section 848 rather than attempt to replace the entire accounting paradigm. I am inclined to think that this practice will continue absent a dramatic change in statutory accounting.

I think the real question may be what adoption of this accounting guidance indicates about the nature of the industry and its products. For instance, unbundling, which I am sure we will talk about later, is potentially a radical departure from the current statutory and tax accounting models. The question of how to unbundle, what, if anything, the results of unbundling will demonstrate, and how this will be interpreted by the various stakeholders in the tax system are all factors that could affect the potential for legislative action. At this point we do not know what, if anything, unbundling will demonstrate.

Peter: What do you think a legislative change triggered by the new accounting rules would look like?

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Craig: I see a problem: if you want to replace the current tax system for insurance, particularly life insurance, what do you replace it with? The current reserve alternatives, such as those in the Exposure Draft or principle-based reserves, may be problematic from a policy perspective. One of the fundamentals of our tax system is supposed to be the concept of "fairness," which is generally interpreted to mean that similarly situated taxpayers pay the same amount of tax. This objective is fairly easy to meet in the current tax system which prescribes, in great detail, virtually all of the assumptions, methods, etc. that are to be used in calculating income. While not everything is prescribed, the range of potential outcomes possible between taxpayers issuing similar life insurance contracts, for instance, is generally relatively narrow. The alternatives such as PBR or the model in the Exposure Draft have much greater degrees of judgment allowed and required, whether it be in choosing mortality assumptions, discount rates, policyholder behavior assumptions, or any number of other things. The result is a much greater range of potential outcomes and a system that is much more difficult for the tax authorities to manage and administer. It would seem to me that policymakers may have a choice between the current tax system, or something very much like it, and a set of alternatives that they may find unpalatable because it will be too difficult for them to regulate.

Lastly, the available alternatives also seem to produce more volatility than the current system which produces a relatively steady stream of income over time, primarily due to using dynamic assumptions. It is not clear to me why tax policymakers would prefer an accounting model that produces greater volatility and less predictability.

Peter: Your point on volatility is a good one and is a major concern of the non-tax commentators on the Exposure Draft. I assume that volatility in financial results would make it more difficult to price products. But, I am not so sure whether it would make matters better or worse if financial accounting has the volatility you are concerned with. At least for now, the tax regime generally remains on a deterministic basis.

I agree with you that the IRS and Congress have expressed concerns that similarly situated insurance companies should be taxed in the same manner when issuing similar products. But, that principle should not mean necessarily that their deductible tax reserves should be the same. It seems to me that allowing different reserve amounts based on actual experience is no different than two service providers that have different profit margins because of their different levels of expenses. No one would suggest that these service providers should accrue the same amount of expenses for tax purposes just because they are competitors that offer the same product. A level playing field is better maintained by attempting to bring taxable income more closely aligned with economic income for all companies, regardless of whether that principle yields different reserve amounts for similar products.

Chris: The Exposure Draft methodology uses "up-to-date" assumptions in computing insurance liabilities. This approach can be characterized as an "active" or "dynamic" valuation methodology, unlike the current tax model, which is a "passive" or "static" approach in which valuation assumptions do not generally change over the life of a policy once they are set. Current reserve methodologies, including principle-based reserves, are moving toward dynamic valuation approaches in which assumptions are changed periodically, often annually, to reflect changing market conditions. Even a deterministic system, which is based on a single assumption set, will result in increased volatility under a dynamic reserve system, as the effect of a change in assumptions is fully reflected in the year in which the change is made. However, the price of limiting volatility in a static system is that the valuation basis is always likely to be more or less obsolete, so increased volatility may simply be the reflection of the change in the underlying value of the liabilities. However, whether that is desirable for determining taxable income is a matter of opinion.

I would like to turn the conversation to the "margins" approach of the Exposure Draft and its possible application to the determination of taxable income. By its very nature, insurance is different from most commercial transactions because the income (premiums) is received before the service (claims) is rendered. As a consequence, any financial accounting system for insurance, whether statutory, GAAP or tax, must make an allowance for future claims and expenses beyond simply measuring current cash flows. For short duration contracts, this may be as simple as an unearned premium reserve, which recognizes net income over the policy duration. For longer duration contracts, this is the role of reserves. However, once a reserve system is introduced, the annual emergence of income under an insurance contract will be influenced by the reserves. This has always been a dilemma for taxing insurance companies. As I mentioned in the introduction, various systems have been used over time, based on some combination of actuarial

science, tax theory and projected tax revenue, not always in that order. However, fundamental to all approaches is the recognition that an allowance is needed so that increases in reserves, or investment income on reserves under an investment income-based tax, should be excluded from the tax base in determining the taxable income of a life insurance company.

In theory, the recognition of reserves can either be explicit, by recognizing premiums as income and allowing a deduction for reserves, or implicitly, through a "margins" approach similar to the classical three-factor dividend formula. The Exposure Draft approach, as well as the current FASB Draft, uses a sophisticated "margins-based" approach for the income statement. Under this method, premiums and claims are treated as balance sheet deposits received and repaid, and thus, do not appear on the income statement. Could a "margins-based" approach to taxable income, similar to the direction of IFRS, be workable for taxing life insurance companies?

Peter: I believe that the margins-based approach of IFRS brings into focus the tax policy considerations relating to the level of reserves that should be allowed in an appropriate income tax regime for life insurance companies.

In the 1959 Act, life insurance company taxable income, and its tax reserves component, generally were determined based on statutory income. Under this taxable income model the level of tax reserves was based on distributable statutory earnings. The concept is that life insurers should not be required to pay tax on profits unless and until they can distribute those profits to their owners. While this concept has not been accepted generally for other types of taxpayers, it could be considered appropriate for life insurers because they are required to hold surplus for the protection of policyholders. The argument is that, because of the social utility of life insurance, surplus should not have to be built-up with after-tax earnings until those earnings are available for distribution to shareholders.

In the 1984 Act (as amended in the 1987 Act), Congress departed from the distributable-statutory-earnings model, and attempted to measure tax reserves as the economic present value of future benefits (less the present value of future premiums). The 1984 Act, as amended, does this in a very crude way. Section 807(d) of the Code requires the reserve discount rate to be determined by a federally prescribed rate which is intended to result in a more realistic present value of future benefits. The 1984 Act does not eliminate all the conservatism in statutory reserves, however, to the extent that standard mortality tables and other statutory reserve assumptions include an implicit margin for adverse claim experience.

By making the margin in reserves explicit, IFRS highlights the fact that tax reserves under current law include elements of conservatism, and this may cause tax policymakers to consider whether the current law should be amended to limit the deduction to a more economic level of tax reserves. I expect that some tax professionals, even in the industry, would view "economic" tax reserves without a margin as the proper approach to achieve matching of premium income and reserve deductions because, in concept, both sides of the premium/claims equation essentially would be computed on a "fair market value" basis. But, I believe that this view is wrong. What this tax reserve model ignores is that the gross premium charged is not only based on the expected value of the liabilities, but includes a charge for assuming the risk of possible adverse experience. To the extent claims emerge as expected, the risk charge becomes the insurer's profit. Consequently, the effect of adopting the economic reserve (without margin) model for tax reserves would be that the insurer's entire anticipated profit for its long-term commitment would be included in taxable income up-front when the premium is received, rather than spread over the period the risk is extant and the premium is earned.

Could a "margins-based" approach to taxable income, similar to the direction of IFRS, be workable for taxing life insurance companies?

It has been argued that insurance is no different from the situation where prepaid fees for services are required to be included in income before the services are performed and the fees are earned. But, insurance is different from products offered by other industries for two reasons. First, unlike the typical prepaid fees for services situation, an insurer's prepaid "income" is received long before the "services" are performed. Second, unlike the case of prepaid fees for services, an insurer's "services" are to pay cash in the form of claims. As a result, premiums have more characteristics of a deposit than prepaid service income in other types of businesses.

Chris: Funny that you should say that. In fact, a well-regarded insurance textbook from the 1930s, Maclean's *Life Insurance*,

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contains a statement echoing yours that "premiums received by life insurance companies are not income in the same sense as the income of an ordinary commercial corporation, but rather are deposits creating a liability and are comparable, for this purpose, to deposits in a bank." I could make an argument that a margin-based approach is conceptually a variation of the "excess interest" tax base used for insurance companies from 1921 to 1959. During this period the life insurance industry was taxed on its investment income "margin." That is, net investment income less required interest on reserves, *i.e.,* the interest "margin." I am not suggesting that Congress readopt the Revenue Act of 1921, but it does illustrate that there is a long-standing precedent in the field of life insurance taxation relative to a tax based on margins. However, at the time, it was characterized by E.E. Rhodes, as "a true income tax upon the only real source of income which life insurance companies have."[2] Rhodes also commented that, "While premiums paid under a contract are consideration for the contract, it does not follow that such premiums constitute income."[3] Given the precedent for a tax system for insurance companies where income is determined based on the emergence of margins, how would you define the taxable income of an insurer under an IFRS-based system?

Peter: I think a better approach than the present-value-of-benefits model for reserves is a tax system that attempts to spread the insurer's risk charge over the period to which the risk relates so that income is clearly reflected annually over the time the premium is earned. This is the basic approach of the IFRS Exposure Draft relating to accounting for insurance contracts. For this reason, I think that the IFRS proposal actually is a useful tool to support the basic argument that margin in reserves is necessary to clearly reflect income. An earlier IFRS proposal sought to measure the risk charge by a "current exit value" whereby the margin in reserves would be measured by the amount a third party would pay to assume the liabilities. The current Exposure Draft shifts the focus to the insurer and measures the margin by the amount the insurer would be willing to pay to have someone assume the liability. To the extent a gross premium is charged in excess of this basic margin, the Exposure Draft would require a residual margin to be amortized. FASB's Discussion Draft does the same thing in concept but combines the margin into a composite amount. The measure of the liability is dynamic in that it is adjusted periodically to reflect current experience. Thus, if claims experience is favorable, the margin is adjusted prospectively so that more profit is reported and conversely annual losses or smaller profits would emerge if claims experience is greater than expected.

In my view, this is a better answer from a tax policy standpoint because it results in a matching of premium income with claims and expenses, and profits and losses emerge as they are earned. The key difference in this approach from the present-value-of-benefits model for reserves is that it focuses on how much premium should be currently recognized in income, with the reserve acting as a deferral mechanism for appropriate annual income recognition. The approach does not focus exclusively on reserves purely as a measure of the expected liability.

Chris: One interesting aspect of the IFRS Exposure Draft is that it does not make distinctions about the type of insurance business, except for adjustments made for certain short-duration contracts. Typically, life insurance and property-casualty insurers have used different statutory, GAAP and tax accounting methods. However, the Exposure Draft does not differentiate by the type of business, so the principles outlined apply equally to both life insurance and property/casualty contracts, leading to the convergence of GAAP accounting methods. Peter, do you think this convergence could have tax policy implications?

Peter: I do. The IFRS Exposure Draft raises the question whether there is any good reason to retain current tax law's distinction between life and nonlife insurance companies. Historically, life and nonlife insurance companies have received different tax treatment based on their company-wide status. If more than half of the reserves of an insurance company are life insurance reserves as specially defined in section 816(b), the company is taxed as a life insurance company. This different treatment based on the status of the company generally follows the NAIC's approach to filing Annual Statements where the status of the company dictates the color of the financial statement that is filed. In the 1984 and 1986 Tax Acts many of the distinctions between life and nonlife companies were eliminated, particularly with respect to life insurance reserves. But, many differences still remain. The most important of these are probably the proration rules for tax-exempt income and the dividends-received deduction and limitations on consolidation and the use of nonlife losses. There are many other distinctions too.

The IFRS Exposure Draft generally applies the same rules for reserves regardless of the type of insurance company. There are special rules for short duration contracts (which many commentators believe should be expanded significantly), but essentially the same reserve standards apply across the board.

If the NAIC were to adopt some version of IFRS, presumably there no longer would be a need to have different types of Annual Statements. In that event, I think a reevaluation of current tax law with a view to eliminating the remaining differences between life and nonlife insurance companies would likely occur.

One way to look at IFRS is that the proposed reserve methodology is similar to how claim reserves are currently determined for many property/casualty lines of business with an explicit margin rather than an implicit margin built into the claim projection factors. That is, claim reserve estimates, as typically determined now, are periodically updated based on the most current information available with a margin added for moderately adverse conditions so that the reserves are "good and sufficient" for the actuarial certification. So, adoption of IFRS may not be a radical change for some property/casualty companies.

Chris: As used in the Exposure Draft, the term "unbundling" refers to the bifurcation of a contract into two components, one that is accounted for as an insurance contract under the "building block" approach and another that is accounted for as a financial instrument. The Exposure Draft requires unbundling of a component which is not "closely related" to the insurance coverage. While the term "closely related" is not explicitly defined in the Exposure Draft, examples of components that should be unbundled include: (1) an investment component reflecting an account balance that is credited with an explicit return where the credited rate is based on the performance of a specified pool of assets and all investment performance is passed to the policyholder; (2) embedded derivatives that would be separated from their host contract under IAS 39; and (3) goods and services not closely related to the insurance coverage. One argument for unbundling is that it maintains consistency between the deposit component of an insurance contract and a separate but otherwise identical financial instrument that is not a part of an insurance contract. However, the ACLI has pointed out, "unbundling of components would misrepresent the nature of the business and add undue complexity."[4] From a tax perspective, does unbundling complicate or simplify the reporting of income for life insurers?

Craig: Unbundling introduces a tremendous degree of complexity. Unbundling as defined in the Exposure Draft requires a company to determine which components are closely related to the insurance coverage. Then a company would have to separately report the pieces of the contract associated with each component.

From a tax policy standpoint, unbundling has many of the same issues that the Exposure Draft has generally. There is a tremendous degree of judgment that must be exercised in assessing what components are to be unbundled and what assets and liabilities and items of income and expense are associated with each component. One would expect that companies will reach different conclusions about unbundling. For instance, many of the comments on the Exposure Draft indicate that its examples of situations where unbundling is required actually are situations where the components are closely related. Thus, there is confusion and disagreement around this most fundamental point. While the users of financial statements may be able to evaluate a company's positions relating to unbundling and evaluate those decisions, I am concerned with how useful and administrable unbundling would be from a tax perspective. At least today the tax authorities are not equipped with the actuarial resources necessary to evaluate the decisions companies would make in this area. Even assuming that the taxing authorities did have the resources necessary, I would question whether a statute could be drafted that would allow taxpayers, the tax authorities and the courts to assess and determine when unbundling is correct with the degree of precision our tax system seems to require.

One way to look at IFRS is that the proposed reserve methodology is similar to how claim reserves are currently determined for many property/casualty lines of business with an explicit margin rather than an implicit margin built into the claim projection factors.

Chris: Another practical concern with unbundling is the characterization of the unbundled components of the contract. Under section 7702, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law. The legislative history for section 7702 excludes from life insurance treatment "an insurance arrangement written as a combination of term insurance with an annuity contract or with a premium deposit fund," on the basis that "all elements of the contract are not treated under State law as providing a single integrated death benefit." Thus, tax law looks to the state law characterization of

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a contract as "a single, integrated life insurance contract" to determine the tax treatment.[5] If components of a contract are separated for accounting treatment, it could create some uncertainty related to the policyholder tax treatment, particularly if IFRS principles were extended to NAIC statutory accounting. However, as a practical matter, it may not be all that easy to separate the revenue and cost associated with the contract components.

I would like to bring the discussion to a close by thanking Peter and Craig for their thought-provoking comments. As Peter observed, the 1984 Act has held up well, but is increasingly under pressure to accommodate new product designs and the accompanying reserve requirements. Craig pointed out that this trend could continue as products evolve in response to the new accounting requirements. At the same time, a critical issue that must be confronted in any discussion on replacing the 1984 Act is what to replace it with. Peter suggested that a "margins" approach similar to that described in the Exposure Draft could be one way to proceed, through the development of a system in which taxable income follows the release of margins, recognizing revenue as the insurer performs under the contract. However, any change to a more dynamic valuation system would lead to increased volatility of income, as well as a lack of uniformity among taxpayers, neither of which is desirable in a tax accounting method. Unbundling may also have implications, but seems to need additional guidance to be performed consistently, which may also create issues in adapting IFRS to tax.

While our discussion may not have provided many answers, we hope that it added some insight to the potential tax consequences of the adoption of IFRS.

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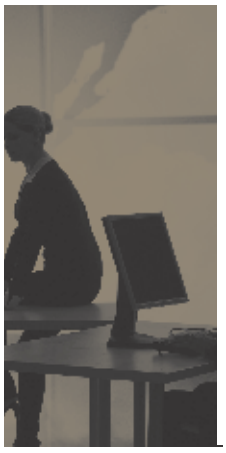
DEACTIVATING THE WEAPONS OF MASS VOLATILITY:
THE DODD-FRANK ACT, SECTION 1256 AND THE TAXATION OF DERIVATIVES

By John R. Newton



INTRODUCTION

In the wake of the financial crisis of 2008, much attention has been focused on derivatives and the alleged threat they pose to the economy at large. For life insurance companies, hedging with derivatives is a long-established and essential tool in managing business and financial risks. In the view of some, however, derivatives pose systemic risk to the global economy, and are perceived to be dangerously arcane instruments that are traded in a high-volume but unregulated "shadow market."[1]

In large part due to this sudden notoriety, derivatives market reform measures were enacted under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (referred to in this article as the "Act"), which was signed into law in July of 2010. Title VII of the Act requires that most types of derivatives that are currently bought and sold over-the-counter—that is, directly between two counterparties rather than on an exchange—be traded through a central clearinghouse. Title VII also requires margin posting for derivative trades, and imposes additional rules for derivative dealers and large-scale derivative market participants.

On the very last of the Act's 848 pages, one finds "Title XVI – Section 1256 Contracts." Title XVI contains a single section—1601—which is the only provision in the entire legislation that amends the Internal Revenue Code (the "Code"). Section 1601 provides that a "section 1256 contract" does not include "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement."[2]

Section 1601 was aimed at ensuring that Title VII's new requirements for derivative trading would not inadvertently—or at least unthinkingly—sweep certain derivatives into the mark-to-market/capital gain regime of section 1256 of the Code. Section 1256 treatment for such contracts could have resulted in adverse tax consequences to companies that routinely use derivatives to manage risk by hedging, such as life insurers, including dramatically increased volatility in taxable income.

While section 1601's "fix" for these concerns is not perfect, for the most part it succeeds in maintaining the status quo for tax treatment of derivative contracts, under which income is required to be recognized only upon a realization event. Section 1601 may also have the important consequence of compelling the Internal Revenue Service (IRS) to provide much-needed guidance on certain financial products such as credit default swaps.

SECTION 1256—BACKGROUND

Section 1256 represents a departure from the general tax principle that income is not taxed until realized (either in cash, or in the case of an accrual-based taxpayer, when it accrues). It was enacted in 1981 at a time when Congress was concerned that taxpayers were using straddle schemes, frequently involving futures contracts, to delay payment of taxes.[3] For example, a taxpayer would enter into offsetting positions by buying a futures contract for the delivery of a certain amount of a particular commodity (the long position), and then selling a futures contract on the same commodity (the short position). Because the positions offset, the two contracts taken together would not fluctuate in value as market conditions changed. However, one contract would always be in a loss position and the other would be in a gain position. The taxpayer would close out the loss position and take a tax deduction. The taxpayer would then continue to hold the gain position, deferring the recognition of taxable gain until a later tax year.

Section 1256[4] addressed this timing play by introducing a mark-to-market system for certain derivatives, notwithstanding the view of some that mark-to-market tax accounting represented a "fundamental departure from the concept of income realization in the U.S. tax law."[5] Thus, a contract subject to section 1256 was now taxed as if its owner had sold the contract on the last day of the tax year, forcing recognition of the contract's change in market value.

Section 1256 initially applied only to a "**regulated futures contract**," defined as a contract:

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(A) with respect to which the **amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market**, and
(B) which is traded on or subject to the rules of a **qualified board or exchange**.

The term "qualified board or exchange" means any of the following:

(A) a national securities exchange which is registered with the Securities and Exchange Commission,
(B) a domestic board of trade **designated as a contract market** by the Commodity Futures Trading Commission, or
(C) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section.

Section 1256(g)(1). [Emphasis added.]

Later, section 1256 was expanded to cover "foreign currency contracts," a category which generally includes forward contracts in actively traded currencies, and non-equity options traded on or subject to the rules of a qualified board or exchange. The character of mark-to-market gain under section 1256 is split arbitrarily between 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, regardless of how long the taxpayer has held the contract.

DODD-FRANK, DERIVATIVES AND SECTION 1256

At the time the Dodd-Frank Act began to take shape, there was little doubt that over-the-counter derivatives, (*i.e.,* derivative contracts not traded on an exchange) such as interest rate swaps and other notional principal contracts, were not subject to the mark-to-market/capital character regime of section 1256. Rather, the specific rules applicable to such contracts applied. For example, the notional principal contract rules of Treas. Reg. section 1.446-3 applied to interest rate swaps, as well as to currency swaps for which no principal amounts are exchanged. Under these specific derivative rules, marking-to-market is generally not required except for dealers in securities. Rather, taxable gain or loss is recognized on a realization basis—that is, when a contract terminates at a gain or loss (requiring an exchange of cash) or when periodic payments are made or have accrued.

Without section 1601 of the Act, the new derivative clearing requirements of Title VII could have changed this treatment for a large number of derivatives by forcing them within the definition of "regulated futures contract" under section 1256(g)(1) (quoted above). The reason for this is that Title VII requires most "swaps" to be cleared through a central counterparty (a "clearinghouse") and traded on a regulated exchange or facility that imposes a margin requirement.

Definition of swap. The term "swap" is broadly defined by section 721 of the Act, and covers a wide variety of derivatives such as interest rate swaps and credit default swaps, as well as energy and even weather-related derivatives. Although certain contract types such as futures are excluded from the "swap" definition, foreign currency swaps and foreign currency forwards are included unless the Secretary of the Treasury specifically excludes them in future guidance.

Trading requirement. Under the framework of Dodd-Frank, the Commodity Futures Trading Commission (CFTC) is directed to review categories of swaps on an ongoing basis to determine whether they should be cleared. If the CFTC makes a determination that a type of swap is to be cleared, and such swap is accepted for clearing by a clearing organization, the swap must be traded on either a "designated contract market" or "swap execution facility." Act, section 723. The significance of this requirement for tax purposes is that a "designated contract market" (a type of organization that is defined under existing law in the Commodity Exchange Act) is a "qualified board or exchange" under section 1256(g)(1)(B).

Margin requirement. Dodd-Frank also requires "a margin… from each member and participant of a derivatives clearing organization [that] shall be sufficient to cover potential exposures in normal market conditions." Additionally, money settlements are required at least daily. Act, section 725. This would result in swaps meeting the criteria of section 1256(g)(1)(A) by establishing a system of deposit based on marking contracts to market.

Again, but for section 1601 of the Act, this combination of the trading and margin requirements would have meant that "swaps" subject to the clearing requirement of Dodd-Frank would be section 1256 "regulated futures contracts" if traded on a "designated contract market."[6] Contracts traded on a swap execution facility would not be "regulated futures contracts" because such a facility is not a "qualified board or exchange." However, a swap execution facility could be

treated as a qualified board or exchange if the Secretary of the Treasury determines that the facility has rules adequate to carry out the purpose of section 1256.

DISADVANTAGES OF SECTION 1256 TREATMENT

Why does expanded section 1256 treatment concern corporate taxpayers? The main reason is vastly increased taxable income volatility. Many corporate taxpayers use derivatives to manage business and financial risks. Typical derivatives used for this purpose may include interest rate swaps, currency swaps, and other contracts that are not marked-to-market under current law. For such taxpayers, an expanded mark-to-market system of tax accounting could result in dramatic changes in taxable income if interest or exchange rates shift by even a small amount. Since such shifts are by their very nature unpredictable, mark-to-market throws a wrench into the machinery of forecasting taxable income. Tax forecasting is essential to any company that needs to make intelligent decisions about entering into transactions that have tax implications.

The capital character treatment required by section 1256 has further disadvantages for corporate taxpayers. Capital losses have the ability to offset only capital gains and not ordinary income, and have a shorter carryforward period (five years) than net operating losses (15 years for life insurance companies; 20 years for all other corporations). Moreover, unlike individual taxpayers, corporations do not benefit from a lower rate on capital gains. Although gains and losses on foreign currency contracts would remain ordinary under IRC section 988, mark-to-market gain or loss on interest rate swaps, for instance, would become capital, thereby increasing the overall likelihood that a company will have a net capital loss carryforward.

Finally, expanding section 1256 to derivatives such as interest rate swaps would be detrimental to insurers who routinely hedge assets.[7] In particular, mark-to-market treatment exacerbates the challenges posed by the straddle rules. If offsetting positions form a straddle, as defined in IRC section 1092, any losses in one position generally must be deferred to the extent of unrecognized gains in the other position. Thus, mark-to-market gains on a derivative that is part of a straddle are recognized immediately, but losses could be deferred if there is unrecognized gain in the offsetting position. Enlarging the scope of section 1256 would increase the incidence of this asymmetrical result, and impose significant tracking and compliance burdens that are not necessary under current tax accounting rules (whereby, for instance, neither an interest rate swap nor a bond is marked-to-market for tax).

THE "FIX" OF SECTION 1601

For the above reasons, a number of taxpayers in the financial services industry, led by life insurance companies, urged Congress that the derivatives provisions of Dodd-Frank not be allowed to expand the scope of section 1256—that is, that the existing state of the tax law applicable to derivatives should be maintained. The result was section 1601 of the Act, which amends the definition of "section 1256 contract," by adding section 1256(b)(2)(B). As noted above, that section provides that "[t]he term 'section 1256 contract' shall not include … any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement."

Beyond its primary effect of mostly maintaining the status quo of the tax law affecting derivatives at the time of Dodd-Frank's enactment, section 1601 is noteworthy—and problematic—for a number of reasons. It was added at the very end of the Conference Committee deliberations. As noted above, it was the only provision of the only tax title in the Act. The derivatives excluded from section 1256 are identified by common market names without reference to any existing definitions in the Code, Treasury regulations, or in the Act itself. Taxpayers and the government now must assess any collateral impact section 1601 has by virtue of how it is drafted.

Since such shifts are by their very nature unpredictable, mark-to-market throws a wrench into the machinery of forecasting taxable income.

At a minimum, some guidance would appear to be necessary on the scope of the exclusion from section 1256. Indeed, most of the contract types specifically listed in section 1601 are not defined in the Code or by regulation. While the excluded contracts resemble those mentioned within the definition of "notional principal contract" found in Treasury regulations,[8] the list is not identical. What constitutes a "similar agreement" to those contracts specifically listed is also unclear—for example, whether "similar agreements" include contracts

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explicitly identified under the definition of "swap" elsewhere in the Act.

Section 1601 also represents the first time the term "credit default swap" has surfaced in the Code. The IRS had previously solicited public comment on the tax treatment of credit default swaps, which more than any other derivative type were an object of opprobrium following the financial crisis.[9] One wonders whether the explicit appearance of "credit default swap" in the Code creates additional incentive for the IRS to finally issue guidance on their treatment, whether as notional principal contracts, put options or as an entirely new type of derivative.[10]

CONCLUSION

Section 1601 of the Dodd-Frank Act prevents what would have been an expansion of the mark-to-market regime of section 1256 through a non-tax piece of legislation. The merits of broadening mark-to-market treatment to cover more types of financial instruments will continue to be debated.[11] The enactment of section 1601 at least assured that such broadening did not occur in a rushed manner, and without due consideration of tax policy goals and the potentially harmful volatility consequences for taxpayers that use derivatives for normal risk management purposes.

END NOTES

1. In the aftermath of the 2008 financial crisis, this view has been pervasive in the popular media. *See, e.g.,* "*Wall Street's Shadow Market,*" *60 Minutes,* first aired on CBS, 10/5/2008, as well as Warren Buffett's oft-quoted statement that derivatives are "financial weapons of mass destruction." *Wall Street Journal,* "Deal Near on Derivatives" (April 26, 2010).
2. New Internal Revenue Code section 1256(b)(2)(B).
3. Kleinbard, Edward, and Evans, Thomas, "The Role of Mark-to-Market Accounting in a Realization-Based Tax System," *TAXES – The Tax Magazine*, 12/1/1997. pp. 801–808.
4. Enacted by the Economic Recovery Tax Act of 1981, P.L. 97-34.
5. Hammer, Viva, "U.S. Taxation of Foreign Currency Derivatives: 30 Years of Uncertainty," *Bulletin of International Taxation,* March 2010, footnote 1, quoting statement of Robert K. Wilmouth, president, Chicago Board of Trade. It should be noted that the perceived timing abuse was also addressed by the simultaneously enacted straddle rules of IRC section 1092, arguably making section 1256 redundant in this respect.
6. At a recent panel discussion, representatives of the IRS stated that the IRS historically has held a narrow view of the scope of "regulated futures contract" under section 1256, such that contracts like interest rate swaps, for example, would not fall within that definition. "IRS Holds to Narrow View of Futures Under Dodd-Frank," *Daily Tax Report* (Bureau of National Affairs, 12/15/2010). However, this view is not specifically supported by the explicit language of the Code, which includes "any contract" in the definition of "regulated futures contract."
7. The ability to designate derivative contracts as IRC section 1221 tax hedges, or to integrate them with debt instruments under IRC sec. 988(d) or Treas.Reg. 1.1275-6, may mitigate volatility. However, these options have limited availability, particularly in respect of routine asset hedges of capital assets.
8. Treas.Reg. sec. 1.446-3(c)(1).
9. See footnote 1, *supra.*
10. The IRS previously requested public comment on how credit default swaps should be treated for tax purposes in Notice 2004-52. No guidance has been issued to date. Due to the increasing variability in how credit default swaps can be structured, issuing such guidance is perhaps an even greater challenge now than previously.
11. See Kleinbard and Evans, *supra* at 823, discussing the lack of necessity for section 1256's mark-to-market regime to curb abuse given the straddle rules, and describing section 1256 as "an odd provision," and "badly in need of repair." A more "pro-mark-to-market" position—though coupled with the view that section 1256 is in need of a general rewrite—may be found in Sheppard, Lee, "Dodd-Frank Bill Blows Up Section 1256," *Tax Notes Today* (Aug. 16, 2010).

IRS ISSUES NOTICE 2011-02 IN CONNECTION WITH THE NEW $500,000 COMPENSATION DEDUCTION LIMIT

By Daniel Stringham

Section 162(m)(6) of the Internal Revenue Code (the "Code"), which was added to the Code in 2010 as part of the Patient Protection and Affordable Care Act, limits the deductibility of any compensation paid by certain health insurers to an individual (generally an officer, director or employee) to $500,000 per year beginning after 2012. According to one of the principal authors of this new provision of the Code, the provision was enacted in order to prevent insurance companies, and insurance executives, from profiting when millions of new customers purchased health insurance for the first time as a consequence of health care reform.[1] The immediate concern with section 162(m)(6) was that it could potentially reach beyond traditional health insurance companies and apply to life insurance companies, or highly diversified companies, with legacy health insurance business and/or that currently sell relatively small amounts of health insurance or other specialty insurance products. On Dec. 22, 2010, the Internal Revenue Service (IRS) issued Notice 2011-02 (the "Notice"), which answered many, but not all, of the questions raised by section 162(m)(6). Importantly, it also generally limited the scope of the section to traditional health insurance companies.

BACKGROUND

By way of background, section 162(m)(6) generally limits the compensation deduction to $500,000 per year for services provided by an officer, director and employee of "covered health insurance providers" ("CHIPs"). The definition of a CHIP is dependent upon the tax year in question. For taxable years beginning after Dec. 31, 2009 and before Jan. 1, 2013, a CHIP is a health insurance issuer that receives premiums from providing health insurance coverage.[2] Health insurance coverage is generally defined as benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract or health maintenance organization contract offered by a health insurance issuer.[3] Health insurance coverage does not include such products as accident or disability income insurance or any combination thereof, medical benefits that are supplementary to liability insurance, liability insurance (including general liability insurance and automobile liability insurance), workers' compensation insurance, automobile medical payment insurance, credit insurance, similar insurance coverage specified in regulations under which benefits for medical care are secondary benefits and qualified long-term care.[4]

For taxable years beginning after Dec. 31, 2012, a CHIP is any employer that is a health insurance issuer with respect to which not less than 25 percent of the gross premiums received from providing health insurance is from "minimum essential coverage." In other words, the employer must first determine which of its products fit into the health insurance "bucket" and then further determine which, if any, of those products is also considered minimum essential coverage. The definition of minimum essential coverage has been the source of much of the uncertainty surrounding section 162(m)(6) because the definition provides greater guidance on what is not such coverage than it provides with respect to what is such coverage. For example, minimum essential coverage generally includes government-sponsored programs (such as Medicare and Medicaid), plans sold in the individual market and employer-sponsored plans (generally assumed to be comprehensive major medical insurance sold in the small or large group markets in the state). The statute then goes on to exclude (to mention just a few) such items as coverage for accident or disability income insurance or any combination thereof, supplementary coverage to liability insurance, workers' compensation, automobile medical payment insurance, credit only insurance, limited scope dental or vision benefits, long-term care, nursing home care or fixed indemnity insurance, community-based care, coverage for specified diseases and fixed indemnity insurance.[5]

CONSEQUENCES UNDER SECTION 162(M)(6)

If an employer is classified as a CHIP for the taxable year, section 162(m)(6) classifies that year as a "disqualified taxable

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year."[6] As a consequence, current wages paid after Dec. 31, 2012 in a disqualified taxable year are subject to the $500,000 deduction limitation, which can have a significant adverse tax impact upon corporations with a large number of highly compensated employees. Additionally, the new law applies to deferred compensation (generally referred to as "deferred deduction remuneration"),[7] paid after Dec. 31, 2012 that is attributable to services performed during any disqualified year after Dec. 31, 2009.

THE NOTICE

Many questions, especially for the insurance industry, remained unanswered following the enactment of section 162(m)(6) and became the subject of numerous inquiries to the government. For example, if an employer was a CHIP in the year that compensation was deferred, but was not a CHIP in the year of actual payment (or vice versa), some asserted the statute was less than clear whether the $500,000 limitation applied. It also was not clear whether or how the rules applied to independent contractors, what products constituted minimum essential coverage, or how indemnity reinsurance is treated under the statute. In addition, there was dialogue with the government regarding whether there should be a *de minimis* amount to protect employers with legacy health insurance coverage and the application of the new rules to captive insurance companies and their parent companies. While the IRS did not answer all of these questions, the insurance industry is now in a much better place with the answers provided in the Notice.

Perhaps the most important provision for the life insurance industry in the Notice, which is effective for taxable years beginning on or after Jan. 1, 2010, is the creation of a *de minimis* rule. Accordingly, for taxable years beginning after Dec. 31, 2009 and before Jan. 1, 2013, an employer is not a CHIP if premiums received from providing health insurance coverage are less than 2 percent of the employer's gross revenues for that taxable year.[8] It is important to note that the Notice does not provide a definition of gross revenues for this purpose. For taxable years beginning after Dec. 31, 2012, an employer is not a CHIP if premiums received from providing health insurance that is minimum essential coverage are less than 2 percent of the employer's gross revenues for that taxable year. This *de minimis* rule will likely exempt most legacy health insurance business and possibly small blocks of specialty products where it is not clear whether such products constitute minimum essential coverage.

Additionally, with respect to the proper treatment of deferred compensation, the Notice makes it clear that an employer must be a CHIP in the year of deferral and in the year of actual payment of the deferred compensation in order for the deduction limits to apply.[9] In other words, if the employer is a CHIP in the year of deferral, but has intervening years where the employer is and is not a CHIP, the compensation deduction limit will only apply if the employer is again a CHIP in the year in which the deferred compensation is actually paid. Simply becoming a CHIP in the year of deferral is of no consequence unless the employer becomes a CHIP at a later date.[10]

The Notice also clarifies that certain independent contractors (*i.e.,* those providing substantial services to multiple unrelated customers) are not subject to the compensation deduction limitations[11] and that indemnity reinsurance premiums are not treated as premiums from providing health insurance coverage.[12]

WHAT IS MISSING FROM THE NOTICE?

Absent from the Notice is further clarification regarding the definition of minimum essential coverage, which means that insurers with specialty insurance products must independently determine the impact of the new rules on those products. The Notice does not provide guidance regarding so-called stop loss insurance, although the IRS did recognize that guidance was necessary because the Notice specifically requested comments on the application of the rules to issuers of stop loss insurance arrangements with a low attachment

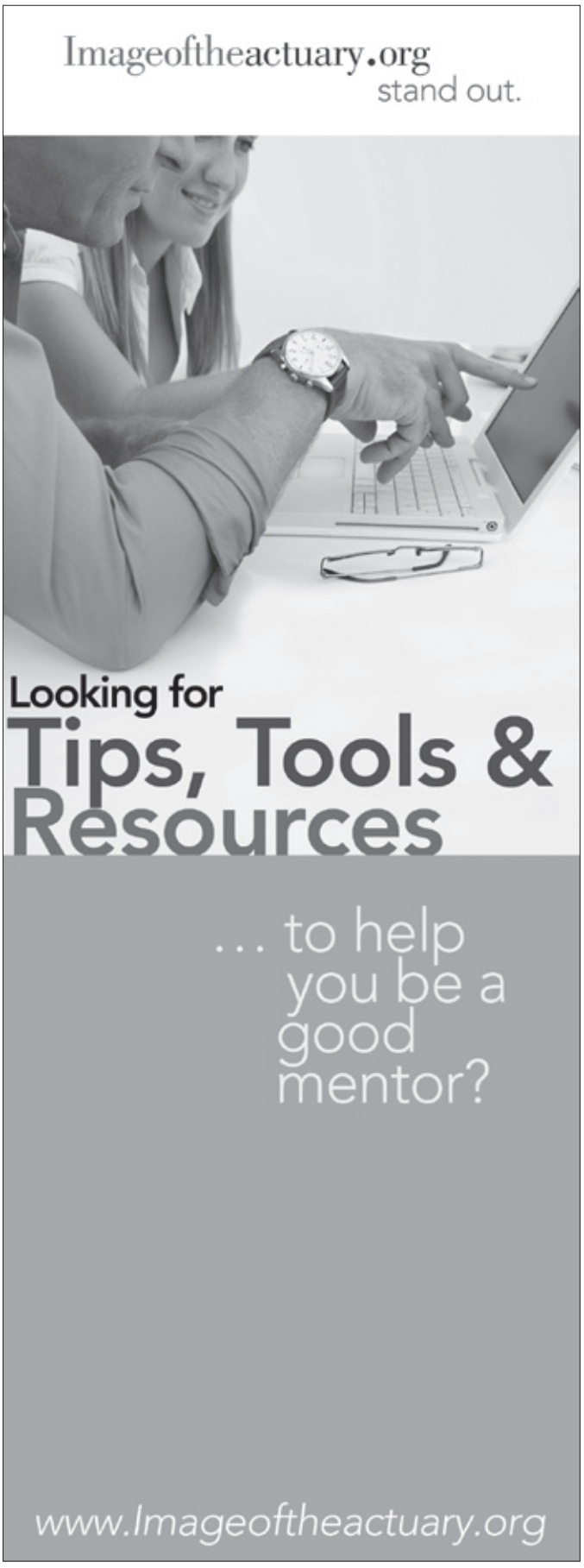
point.[13] The Notice did not provide guidance about captive insurance companies but again requested comments regarding the application of the new rules to captive insurers, along with requests for comments on the meaning of a CHIP in the case of a corporate event such as a merger, acquisition or reorganization and possible alternative *de minimis* rules. Comments on these issues must be submitted by March 23, 2011.

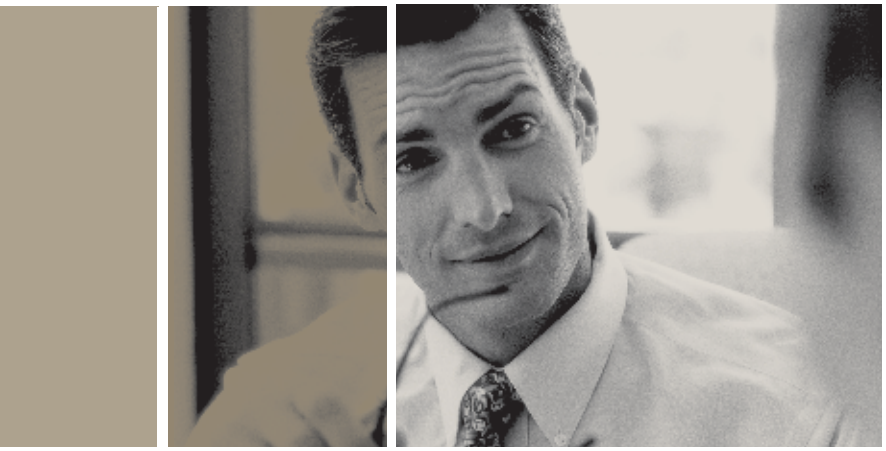
CONCLUSION

While the Notice did not answer every possible question, it did exclude many of the products and fact patterns that caused a great deal of concern when section 162(m)(6) was enacted. There are still outstanding questions, but it is clear from the request for comments that the IRS is focused on the issues most in need of resolution for the insurance industry. Finally, obtaining this guidance before year-end was critical because companies to which the exceptions in section III of the Notice applied would otherwise have had to accrue, in their 2010 financial statements, for "deferred deduction remuneration" earned in 2010 payable after 2012.

END NOTES

1 *See* Dec. 4, 2009 press release issued by Senator Blanche Lincoln (D-AR).
2 Under IRC section 9832(b)(2), a health insurance issuer is generally defined as an insurance company that is licensed to engage in the business of insurance in a state and that is subject to a state insurance regulation. The term does not include a group health plan. Additionally, entities that are aggregated under section 414 of the Code are generally treated as a single entity for these purposes, which can pull noninsurance subsidiaries into the scope of the new rule.
3 *See* IRC section 9832(b)(1) of the Code.
4 *See* IRC sections 9832(c)(1) & (d) and 213(d) of the Code.
5 *See* IRC sections 162(m)(6)(i)(II) and 5000A(f) and 42 USC 300gg-91(c)(1).
6 See IRC section 162(m)(6)(B).
7 *See* IRC section 162(m)(6)(A)(ii) and (E).
8 *See* section III(B) of the Notice.
9 *See* Examples 1 & 2 under section III(A) of the Notice.
10 *See* Example 3 under section III(A) of the Notice.
11 *See* section III(C) of the Notice.
12 *See* section III(D) of the Notice.
13 *See* section IV of the Notice.





THE IRS RULES ON SECTION 7702 ISSUES REGARDING A GUARANTEED DISTRIBUTION RIDER

By Brian G. King

In the fall of 2010, the Internal Revenue Service (IRS) issued a private letter ruling (PLR 201046008) to a taxpayer offering a rider for a variable life insurance contract that provides a minimum annual withdrawal or loan amount, irrespective of the investment performance underlying the accumulation account of the contract (the "Rider"). While the IRS has ruled on guaranteed minimum withdrawal benefits (GMWB) associated with a variable deferred annuity contract, this is the first time the IRS has provided a ruling for this type of product. While similar in concept, there are a number of relevant factors described in the ruling that distinguish the Rider from a typical GMWB on a deferred annuity: 1) the Rider is associated with a life insurance contract; 2) the form of the distribution can vary between a withdrawal and a policy loan; and 3) the policyholder has the ability to alter both the timing and magnitude of the benefit payable under the Rider (unlike a typical GMWB which is generally fixed both in terms of timing and magnitude).

The taxpayer submitting the ruling request asked the IRS to rule on two particular aspects of the contract. The first ruling deals with the proper determination of the cash surrender value under section 7702(f)(2)(A). While similar in certain regards to the private letter rulings the IRS has issued over the past several years dealing with the section 7702(f)(2)(A) definition of the cash surrender value,[1] this ruling provided little in the way of discussion or analysis that would provide further insight into the IRS views on the definition of cash surrender value. The ruling simply confirmed that the taxpayer properly defined cash value in a manner that is consistent with the section 7702(f)(2)(A) definition of cash surrender value.

The second ruling request focused on the effect that the Rider has on the calculation of the net single premium under the cash value accumulation test (CVAT) or the guideline premium limitation. Like the first request, there was little in the way of analysis provided in the ruling to support the conclusion reached by the IRS, that the calculation of the net single premium and the guideline premium limitation were unaffected by the presence of the Rider.

FACTS OF THE RULING

The ruling request provides a rather detailed description of the characteristics of the Rider and the life insurance contracts to which the Rider will be attached. The life insurance contracts are flexible premium variable life insurance contracts (the "Policies") and have features that are consistent with flexible premium variable life insurance contracts available in the market today. The Policies provide for a policy value to which premiums are allocated and interest (or other investment earnings) is credited, and from which certain expense, cost of insurance and other charges are deducted. Policyholders can borrow against the policy value and can elect to receive withdrawals of a portion of the net cash surrender value, or NCSV (*i.e.,* the policy value less surrender charges and outstanding policy loans). In addition, a policyholder can choose between two variations of the Policies, one designed to comply with the guideline premium limitation and cash value corridor (CVC) test of section 7702(a)(2) and another designed to comply with the cash value accumulation test CVAT of section 7702(a)(1).

The Rider is funded by a monthly charge that is assessed against the Policy's cash value. The taxpayer submitting the ruling represents that the Rider and any benefits payable under the Rider are part of the Policies for state law purposes and are not regulated or otherwise treated under state law as an annuity contract or as some other type of non-life insurance contract. Under this view, the charges assessed against the Policy's cash value would not be considered distributions, and would be treated similar to contractual expense or cost of insurance charges. Because the Rider does not meet the section 7702(f)(5) definition of a qualified additional benefit, Rider charges assessed against the Policy's cash value would likely be characterized as distribution (and potentially taxable) if the Rider was considered an additional benefit and not an integrated part of the Policy.

The ruling request describes a number of conditions ("Rider Conditions") that must be satisfied in order for the policyholder to be eligible for the Rider to remain in force. If the policyholder follows the Rider Conditions, the policyholder

will be entitled to the "Annual Rider Benefit," which is the maximum amount that is available for distribution each year during the "Rider Benefit Period." The Rider Benefit Period defines the date on which the policyholder becomes entitled to distributions under the Rider and the number of years over which benefits are payable. Distributions paid under the Rider can take the form of withdrawals or loans, although the ruling does not provide details describing when distributions are received as withdrawals or loans. If the NCSV is insufficient to make a distribution, the policy value would be increased by the excess of the amount of the distribution requested (but not more than the Annual Rider Benefit) over the NCSV. The Rider would therefore infuse cash into the policy value so that the NCSV would have sufficient value to make the distribution (loan or withdrawal) provided under the Rider.

In addition to providing the Annual Rider Benefit, the Rider also guarantees the policy will not lapse if the Rider Conditions are satisfied (*i.e.,* a no lapse guarantee). Accordingly, if the policy value is reduced because of losses in the variable accounts, and is insufficient to fund cost of insurance or other charges under the Policy, the no lapse guarantee will keep the policy in force.

The ruling goes on to describe how the Policies define the minimum death benefit. The Policies' minimum death benefit, without regard to the Rider, equals the product of 1) the applicable minimum death benefit factor (varies based on age and whether the policy is intended to meet the CVAT or the CVC test) and 2) the policy value. If the Rider is present, during the Rider Benefit Period, the minimum death benefit is calculated by multiplying 1) the applicable minimum death benefit factor by 2) the greater of a) the policy value and b) the Annual Rider Benefit. Under this definition, the Annual Rider Benefit would be considered section 7702(f)(2)(A) cash surrender value to the extent it exceeds the policy value.

RULING REQUEST NUMBER ONE

The first ruling request deals with the section 7702(f)(2)(A) definition of cash value. Because the Rider operates in a manner that can infuse money into the policy value, the taxpayer was seeking assurances that it was properly accounted for in defining the minimum death benefit required of section 7702. This would be of particular importance for contracts designed to comply with the CVAT, which must be satisfied by contract terms. Several private letter rulings dealing with the definition of cash surrender value have been issued over the past several years. These rulings all focused on life insurance products that provided for amounts available upon surrender that were in excess of what is generally viewed to be the accumulation account in a universal life type insurance contract. These rulings were the subject of two *Taxing Times* articles published in 2006 and 2009[2] (the "Prior *Taxing Times* Articles"). It is likely that these rulings prompted the taxpayer to seek a ruling request on this product.

Because the cash surrender value is a necessary element for determining the minimum required death benefit, it is important that it be properly defined in the contract. By defining cash surrender value as the greater of the policy value and the Annual Rider Benefit, the Policies take into account the greatest amount that the Rider can increase the policy value at any one time.

Based on the facts presented in the ruling request, it appears that the form of the distribution will impact the effect that the Rider can have on the policy value, which in turn affects the minimum required death benefit. When the Rider Benefit is payable as a policy loan, the Rider will increase the policy value to the extent the NCSV is less than the Annual Rider Benefit. Since the loan will not reduce the policy value (it will reduce the NCSV), any infusion of cash from the Rider would be reflected in the determination of the minimum required death benefit directly through the increase in the policy value.

If the NCSV is insufficient to make a distribution, the policy value would be increased by the excess of the amount of the distribution requested (but not more than the Annual Rider Benefit) over the NCSV.

Alternatively, if the Rider Benefit is payable as a withdrawal, the Rider will increase the policy value to the extent the NCSV is less than the Annual Rider Benefit. When the withdrawal occurs, both the policy value and the NCSV would be reduced accordingly. It would seem that only when the policy value and the NCSV are the same (or approximately the same), that the Annual Rider Benefit could exceed the policy value. When this occurs, the minimum required death benefit would be defined in terms of the Annual Rider Benefit.

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The taxpayer has taken the position that the infusion of cash from the Rider can create cash surrender value in certain instances for purpose of section 7702(f)(2)(A), either directly through the increase in the policy value in the event the Rider Benefit is payable as a policy loan, or indirectly to the extent the Rider Benefit is payable in the form of a withdrawal. It is worth noting that both the taxpayer and the IRS relied on the definition of cash surrender value contained in a 1992 proposed regulation.[3] For a detailed analysis of the available guidance regarding the definition of cash value, including a description of definition of cash value contained in the 1992 proposed regulation, refer to the Prior *Taxing Times* Articles. While somewhat controversial on its reliance on a regulation that is currently in proposed form and is subject to a rule rendering it currently inapplicable (*i.e.,* IRS Notice 93-37), the ruling provided very little in the way of analysis of this issue, perhaps due to the fact the taxpayer adopted a definition of cash surrender value that was consistent with its position in the prior rulings.[4]

RULING REQUEST NUMBER TWO

The second request in the ruling addresses the effect of the Rider on the calculation of net single premiums and guideline premiums, presumably in the at issue calculation and on the later occurrence when the rider infuses cash into the policy value. The IRS seemed to focus on whether the operation of the Rider would trigger an adjustment event, presumably resulting from the increase in the policy value when the NCSV was insufficient to provide the Annual Rider Benefit. The analysis contained in the ruling notes that 1) the factual circumstances underlying the operation of the Rider are not those described in the legislative history describing the changes in future benefits that require an adjustment and 2) that upon issuance of the contract, it is not known if and when the Rider will ever operate to increase the cash value. Based on this analysis, the IRS concluded that the calculation of net single premiums or guideline premiums is unaffected by the Rider.

CONCLUSION

The discussion of the issues in the ruling is limited, including only a restatement of the IRS's view of cash surrender value and a comment that "the factual circumstances here are not those described by the DEFRA Bluebook's discussion of a change in future benefits that require an adjustment."[5] While providing some useful insights into the IRS's view on the section 7702 requirements regarding guaranteed distribution riders, the IRS continues to show reliance on the 1992 Proposed Regulations defining cash value. Now that formal guidance on the section 7702 definition of cash value has made its way on to the IRS Priority Guidance Plan for 2010-2011, clarity may finally be shed on the ongoing controversy regarding the definition of cash value.

END NOTES

1 *See* PLR 200521009 (Feb. 22, 2005), PLR 200528018 (April 12, 2005), PLR 200841034 (March 28, 2008) and PLR 200901028 (Sept. 29, 2008).

2 Craig R. Springfield and Brian G. King, "Private Rulings Regarding 'Cash Surrender Value' Under Section 7702," *Taxing Times*, vol. 2, no. 2 (September 2006) and John T. Adney and Alison Reynolds Peak, "Whither the Definition of 'Cash Surrender Value' – The IRS Issues More Waiver Rulings Discussing the Meaning of Section 7702(f)(2)(A)," *Taxing Times*, vol. 5, no. 2, (May 2009).

3 A key distinction in the definition of cash surrender value is the use of the "or" term. While the legislative history of section 7702 provides a definition of cash value that is based on the amount available "upon surrender and, generally, against which the policyholder can borrow," Treas. Reg. sec. 1.7702-2 substitutes an "or" for the "and" in its definition of cash surrender value. (*See* S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).

4 *See* note 1, *supra.*

5 *See* STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 653-54 (J. Comm. Print 1984) ("DEFRA Bluebook").

ACLI UPDATE

By Walter Welsh and Pete Bautz

In recent months, questions have arisen in some Internal Revenue Service (IRS) examinations of life insurance company tax returns regarding the tax treatment of hedges relating to variable annuity contract guarantees. The American Council of Life Insurers (ACLI) and some of its members are seeking guidance on this issue through an IRS initiative, the Industry Issue Resolution (IIR) Program. This program is designed to address frequently disputed tax issues that are common to a significant number of business taxpayers.

REQUEST FOR IRS INDUSTRY ISSUE RESOLUTION GUIDANCE TO ADDRESS THE TAX TREATMENT OF HEDGES OF VA CONTRACT GUARANTEES

In a letter dated Jan. 7, 2011, outside tax advisors representing several ACLI members requested IRS guidance under the IIR Program regarding the application of the tax rules to the hedging of certain risks attributable to variable annuity contract guarantees. An ACLI letter dated Jan. 10, 2011, also asked the IRS to consider the development of guidance under the IIR Program on the tax treatment of hedges for certain guarantees in variable annuity contracts.

The Guarantees. Benefits available under a variable annuity generally are based on the account value of the contract, which in turn is based on the market value of the underlying separate account assets allocable to the contract. Policyholder premiums are allocated among investment sub-accounts, and a large amount of the assets is invested in equities or equity-linked investments.

Variable annuities sold in recent years often provide policyholders the option of adding one or more guaranteed benefits to the contract. For instance, a guaranteed minimum death benefit ("GMDB") provides a minimum guaranteed amount in the event of the policyholder's death, such as a guaranteed return of premiums paid into the contract. A Guaranteed minimum accumulation benefit ("GMAB") provides the policyholder with a guaranteed minimum account value on a specified date, regardless of the performance of the investments chosen by the policyholder. A guaranteed minimum income benefit ("GMIB") or a guaranteed minimum withdrawal benefit ("GMWB") provides the policyholder with guaranteed payout amounts at future dates if the account value could not otherwise support the benefit.

These variable annuity minimum guarantees subject companies to the risk that they will be required to pay an amount in excess of the account value. Because many of the underlying investments typically are in equities, the cost to the company of providing the minimum guaranteed benefits generally increases as equity values decline. In addition, because the payment of guaranteed contract benefits often is made over a number of years, and GMIBs and GMWBs in particular extend for many years, interest rates have a significant effect on the economic cost of the guarantees and subject the company to exposure to changes in market interest rates.

The Hedges. To manage the long-term risks attributable to the minimum guarantees under variable annuity contracts, companies typically hedge with various derivatives, which may include equity-index options, exchange-traded futures, and equity and interest-rate swaps. The risks in these liabilities are hedged in the aggregate and the hedges are monitored frequently to reflect the current risks in the liabilities and adjusted accordingly. The variable annuity hedging transactions are executed pursuant to state regulatory guidelines that life insurance companies are required to adopt which specify the types of risks that can be hedged.

Treas. Reg. § 1.446-4(b) provides a clear-reflection-of-income standard for tax hedging transactions, which requires that "the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the

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item or items being hedged." However, there currently are no regulations or rules specifically addressing the tax accounting treatment of hedges that have been specifically designed for these recently developed types of variable annuity contract guarantees.

The IIR Program. The IRS's IIR Program is designed to resolve frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers through the issuance of clear and practical published or other administrative guidance. Business taxpayers and other interested parties, like trade associations, can submit suggested issues to the IRS for consideration, and the IRS then screens, evaluates and selects the issues for resolution under the IIR Program. The types of issues that are best addressed through this program are those in which uncertainty exists as to how the tax law applies to a common factual situation found in an industry. In some cases, the IRS ends up providing a safe harbor that can be used by taxpayers whose circumstances fit within the guidelines.

As of press time, the IRS had just notified ACLI and its members that it had decided to address this issue through the IIR Program. ACLI and its members will be meeting regularly with the IRS to discuss the issue itself, as well as the nature and scope of any guidance the IRS might issue. We will update *TAXING TIMES* readers as events unfold.

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T3: *TAXING TIMES* TIDBITS

IRS RULES AGAIN ON CONTINGENT DEFERRED ANNUITIES

By John T. Adney and Bryan W. Keene

In private letter rulings 201105004 and 201105005, each dated Nov. 2, 2010 and released to the public on Feb. 4, 2011, the Internal Revenue Service (IRS) has again addressed the federal income tax treatment of insurance arrangements sometimes referred to as "stand-alone withdrawal benefits" or "contingent deferred annuities." Under such an arrangement, a certificate under a group insurance contract provides guaranteed minimum withdrawal benefits that are linked to an investment account that the certificate owner establishes with a financial institution. The facts of the two new rulings are the same, although the taxpayers and some of the issues addressed differ as between the two. Specifically, PLR 201105004 was issued to an individual taxpayer and dealt with issues pertinent to the certificate owner under the group contract, while PLR 201105005 was issued to an insurance company and addressed company-level issues, some of which overlap with the certificate owner-level issues.

Facts of the Rulings

The facts of the new rulings are similar to private letter rulings the IRS previously had issued on similar products. *See* PLRs 201001016, 200949007 and 200949036, which were discussed in an article published in *Taxing Times* in May 2010.[1] In general, the group contract is to be issued to an entity, labeled the "Sponsor" in the rulings, that offers investment advisory services to individuals and others, including with respect to "Managed Accounts" that the Sponsor advises. Unlike the case with the previous rulings, in which the sponsoring entity was not affiliated with the insurer issuing the contract, the Sponsor in the new rulings is a wholly-owned subsidiary of the issuer.

The group contract authorizes the Sponsor to sell contract certificates to certain individuals who own Managed Accounts with the Sponsor, subject to a periodic fee payable to the insurance company. The individual certificate holder can select some or all of the assets held in his or her Managed Account to be "Specified Assets" associated with the certificate—establishing a linked investment "Account." The Sponsor will then manage that Account in accordance with a specific investment objective identified in the certificate, and the Account owner will be subject to limitations on changing the investment strategy.

After a certain date identified in his or her certificate, each year the owner may withdraw an amount from the Account up to an "Annual Withdrawal Amount" (or "AWA"). The AWA is set, at issuance of the certificate, as the lesser of a specified dollar amount or a specified percentage of the Account value, and over a designated time period the AWA may increase via a "ratchet" or "roll-up" feature. The benefit provided under the certificate is that if the value of the Account is reduced to zero for any reason other than withdrawals or transfers exceeding the AWA, the insurer is obligated to provide the owner with a series of periodic payments equal to the AWA for the remainder of the owner's life.

Individual Tax Issues

In PLR 201105004, the IRS issued the following rulings with respect to the individual certificate owner:

(1) the certificate is an "annuity contract" within the meaning of section 72;[2]

(2) the certificate will not affect the individual's "holding period" with respect to the assets in the Account for purposes of determining whether such assets provide "qualified dividend income" within the meaning of section 1(h)(11), because the certificate does not diminish the individual's risk of loss on Account assets;

(3) the certificate will not affect the individual's ability to deduct investment losses in the Account under section 165(a), because it will not create a right to reimbursement for such losses; and

(4) the certificate and the Account assets will not be

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viewed as components of a "straddle" within the meaning of section 1092.

These rulings are similar to the ones issued in PLRs 201001016 and 200949007 and are discussed in more detail in the prior *TAXING TIMES* article. In addition, the new PLR covered three issues not addressed in the previous PLRs:

- *Amounts received as an annuity.* First, the IRS ruled that if the insurer becomes liable to pay the guaranteed minimum benefits under the certificate, those payments will be "amounts received as an annuity" under section 72(a). The IRS reached this conclusion based on its holding, noted above, that the certificate is an annuity contract within the meaning of section 72, observing in the ruling letter that the amounts payable under the contract met the definition of "amounts received as an annuity" under the section 72 regulations. This conclusion was implicit in the earlier PLRs involving similar products, in that the analysis of whether those products constituted annuity contracts noted that the withdrawal benefits met the definition of annuity payments in the section 72 regulations. The new PLR, however, made this conclusion an explicit holding, at the taxpayer's request.

- *Investment in the contract and adjusted basis.* Second, the IRS held that the periodic fee payable to the insurer under the certificate will be taken into account in determining the individual's "investment in the contract" for section 72 purposes as well as in determining the adjusted basis in the certificate under section 1011. In reaching its conclusion, the IRS cited to sections 72(c)(1) and 72(e)(6), each of which provides that for purposes of determining a contract's "investment in the contract," the aggregate amount of premiums or other consideration paid for a contract must be taken into account. It also cited to section 1011(a), which specifies that the adjusted basis of property (for determining the gain or loss from the sale or other disposition of the property) is its basis as determined under section 1012 or other applicable sections (typically the property's cost) and as adjusted under section 1016. The taxpayer's need for the holding on adjusted basis is not clear from the face of the PLR, but presumably it was connected with the fact, as recorded in the PLR, that the individual's interest in the certificate was transferrable.

- *Short sales.* Third, the IRS addressed the certificate's treatment under section 1233. That section provides rules as to the tax consequences of a "short sale" of property if gain or loss from the short sale is considered a gain or loss from the sale or exchange of a capital asset and the taxpayer holds substantially identical property. The IRS ruled that the certificate is neither a short sale of, nor an option to sell, the Account assets, rendering the provisions of section 1233(b) inapplicable.

Insurance Company Tax Issues

In the PLR issued to the insurance company (PLR 201105005), the IRS ruled, as it had to the individual taxpayer, that the certificate is an annuity contract within the meaning of section 72. This is the same ruling issued to the insurer in PLR 200949036, discussed in the prior *TAXING TIMES* article. The IRS also ruled to the insurer, for the reasons previously described and comparably to the rulings issued to the individual taxpayer, that (1) any guaranteed minimum benefits the insurer becomes obligated to pay will be treated as "amounts received as an annuity" under section 72(a), and (2) the periodic fee payable to the insurer will be taken into account in determining the certificate owner's "investment in the contract" under section 72 and his or her adjusted basis under section 1011. (These issues were not addressed in PLR 200949036.)

In addition, the insurer asked for, and the IRS issued, rulings on two other matters not addressed in the earlier PLRs. First, the IRS held that because the certificate is an annuity contract under section 72, the insurer will not be subject to the "mark-to-market" rules of section 475, based on the "life insurance products" exception to those rules in Treas. Reg. section 1.475(c)-1(d). Second, the IRS ruled that the periodic fee will be included in the insurer's gross income under section 803(a)(1) because of the certificate's treatment as an annuity contract.

Conclusion

Following a long struggle over determining the proper income tax treatment of contingent deferred annuities, both at the individual certificate holder level and at the insurance company level, it now appears that taxpayers and the IRS have come to a basic agreement on that treatment. The fact that more PLRs on this topic are appearing in the public domain demonstrates the solidifying of the IRS's views on the treatment of the product along with a rising interest in the product itself among insurers, mutual funds and others.

END NOTES

1 *See* Joseph F. McKeever, III, and Bryan W. Keene, "IRS Confirms Annuity Status of 'Contingent Annuity Contracts'," *Taxing Times*, vol. 6, issue 2 (May 2010).
2 Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended.

IRS APPROVES WELLNESS BENEFITS IN QUALIFIED LONG-TERM CARE CONTRACTS

By John T. Adney and Craig R. Springfield

Under IRC section 7702B(b)(1)(A), a qualified long-term care ("LTC") insurance contract is an insurance contract under which "the only insurance protection provided … is coverage of qualified long-term care services." If such a contract meets the requirements for treatment as "qualified" for section 7702B purposes, including the requirement just quoted, the benefits provided under the contract receive favorable income tax treatment. This treatment includes, for example, the characterization of the LTC benefits as accident and health insurance excludable from gross income and, in certain circumstances, the deductibility of the premiums under IRC section 213. In two identical rulings issued on Nov. 5, 2010, private letter rulings 201105026 and 201105027, the Internal Revenue Service (IRS) addressed the section 7702B treatment of a "wellness rider" proposed to be issued with or added to so-called stand-alone qualified LTC contracts.

According to these rulings, which were released to the public on Feb. 4, 2011, the wellness rider provides the insured with access to certain information regarding health, wellness and LTC for a dual purpose: "to either facilitate the provision of long-term care services or reduce the incidence or severity of any future need" for LTC. Some versions of the wellness rider also include a voluntary incentive program under which insureds who participate in periodic health assessments and meet certain health standards will be eligible for any premium discounts or benefit increases under their LTC contracts declared by the insurer. The rider is provided by the insurer at no stated additional charge to the policyholder.

The taxpayers that sought the rulings, which were the life insurance companies that issue the LTC contracts and proposed to issue the wellness riders, asked the IRS to rule on two issues arising from inclusion of the rider in an LTC contract. In the first requested ruling, the IRS was asked to hold that issuing the contract with the rider (under either version) would not cause the contract to be treated as providing coverage other than of qualified LTC services. A holding to this effect was essential to the insurers involved, for the reason that section 7702B(b)(1)(A) requires, as quoted above, that qualified LTC contracts provide coverage "only" of qualified LTC services, *i.e.*, any other coverage would preclude the contract from being "qualified" for purposes of section 7702B(a). The second requested ruling was that all of the premiums paid for a contract that includes the rider will be premiums for a qualified LTC contract. This was important to provide assurance, for example, that the entirety of the premiums would be eligible for deductibility under section 213.

In the rulings, the IRS reached favorable conclusions on both issues. With respect to the first issue, the IRS reasoned that the wellness rider, in and of itself, did not provide insurance coverage at all, and so it could not be providing insurance coverage of other than qualified LTC services. As the IRS observed, "[t]he information and incentives provided by the [wellness rider] are not insurance benefits but are a loss prevention program consistent with the purpose" of section 7702B. Thus, the ruling went on, "[i]t would be inconsistent with the stated goal of section 7702B to deny qualification to a long-term care insurance contract because it provided ancillary mechanisms aimed at minimizing long-term care needs." That "stated goal," according to the ruling, was the congressional purpose in enacting section 7702B, *i.e.*, to provide an incentive for individuals to take financial responsibility for their long-term care needs. As to the second issue, for much the same reason as it gave for its holding on the first issue, the IRS held that all of the premiums paid for the contract, regardless of the presence of the wellness rider, would be premiums for a qualified LTC contract. Specifically, the IRS said it saw no reason to recharacterize any contract consideration that could be allocated to the wellness program as other than amounts paid for an LTC contract.

In PLRs 201105026 and 201105027, the IRS took a very reasonable approach to interpreting the restriction in section 7702B(b)(1)(A) that limits qualified LTC contracts to providing "only" the insurance coverage of qualified LTC services. While the two rulings addressed wellness riders to be issued with or added to stand-alone qualified LTC

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contracts, the same reasoning and conclusions presumably would apply to permit similar wellness benefits to be provided in connection with the newer forms of qualified LTC coverages, namely, combination LTC-annuity and LTC-life insurance contracts.

REACTIVATING THE ACTIVE FINANCING EXCEPTION

By Kevin T. Leftwich and Biruta P. Kelly

Insurance companies with controlled foreign corporations ("CFCs") were breathing a temporary sigh of relief with the passage of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "Extenders Bill") in December. Among the impressive list of tax provisions in the Extenders Bill is a short section amending I.R.C. §§ 953(e)(10) and 954(h)(9),[1] which extended the exceptions from Subpart F income for active financing income (the "Active Financing Exception") through tax years beginning before Jan. 1, 2012. Why were companies anxiously awaiting this extension? Because the Active Financing Exception had already expired for all tax years beginning after Dec. 31, 2009, and these companies were on the verge of seeing a potentially significant increase in their Subpart F income.

Foreign income earned by a foreign corporation attributable to a foreign business generally is not taxed in the United States until the income is distributed by the foreign corporation through payment of a dividend to a U.S. taxpayer. However, deferral of taxation is not permitted for Subpart F income earned by a CFC.[2] The goal of the Subpart F rules is to deter taxpayers from using related foreign companies "to accumulate earnings that could have been accumulated just as easily in the United States."[3] The Subpart F rules generally result in the owners of a CFC who are U.S. shareholders being taxed by the United States currently on their pro-rata share of the CFC's Subpart F income. Subpart F income includes "insurance income."[4] Additionally, Subpart F income includes foreign base company income, which includes foreign personal holding company income.[5] Foreign personal holding company income is any income derived from dividends, interest, rents, annuities, certain gain from sale of property, gain from foreign currency transactions, income from notional principal contracts, and amounts received under personal service contracts.[6] So, under the general rule, a significant amount of insurance companies' income earned through CFCs could be at risk of qualifying as Subpart F income.

This result is inappropriate to the extent the income originates from the core active insurance business activities of the CFCs—these are not earnings that "could have been accumulated just as easily in the United States." The Active Financing Exception was created to correct this result by exempting from current inclusion in taxable income certain income derived from so-called "active financing" activities. I.R.C. §§ 953(e) and 954(i) provide for the application of the Active Financing Exception to insurance companies, and exclude from Subpart F insurance income certain "exempt insurance income" and exclude from personal holding company income "qualified insurance income of a qualifying insurance company."[7]

The Active Financing Exception initially was added to the Internal Revenue Code in the Taxpayer Relief Act of 1997[8] as a temporary exception starting with tax years beginning in 1998. The temporary exception was extended, with modifications, five times by Congress between 1997 and 2008. Prior to the passage of the Extenders Bill, as mentioned above, the Active Financing Exception had expired for all tax years beginning after Dec. 31, 2009.[9] This expiration would have resulted in I.R.C. § 953(a) applying to CFCs in the same way it did prior to 1998. While the result is not certain, the Internal Revenue Service's position likely would be that underwriting income earned by the CFC related to insuring risk located outside of its country of origin and most investment income qualifies as Subpart F income. The adverse impact of this result could be magnified due to a rule that causes all the income of a CFC to be treated as foreign base company income, and thus Subpart F income, if the sum of the CFC's foreign base company income and insurance income for a taxable year exceeds 70 percent of total gross income.[10]

Applying the "old" law may not have been as simple as one would hope. Prior to the creation of the Active Financing Exception, the Treasury Department (Treasury) published Proposed Regulations §§ 1.953-0 through 1.953-7. The proposed regulations provided guidance, among other things, on determining when insurance income is earned in or outside of the CFC's country of origin, computing and allocating insurance reserves, and computing and allocating

investment income. The proposed regulations generally were criticized by taxpayers in comment letters, and numerous meetings were held by the insurance industry with the Treasury. The industry thought that revised regulations would be issued, but they were never finalized, presumably in part due to the passage of the Active Financing Exception. It is unclear whether Treasury would have readdressed and finalized the proposed regulations if the Active Financing Exception had not been extended.

If the Active Financing Exception were to lapse, it not only would eliminate the benefit of deferral, it also would add an extra layer of complexity in calculating taxes associated with international activity of insurance companies, as there are a number of issues that would need to be resolved: (1) how do you determine whether insurance income is earned outside the country of origin, (2) how are reserves computed, (3) how is investment income calculated and allocated, (4) how are expenses allocated, (5) will the new rules require changes in method of accounting, and, perhaps most importantly, (6) will the proposed regulations be revised or finalized in the current form? While the Extenders Bill provided a reprieve from the need to address these issues, it is only a temporary one. Without another extension, it will be less than a year before the Active Financing Exception expires again for calendar year CFCs.

END NOTES

1 Section 750 of Extenders Bill.
2 I.R.C. § 951(a). A CFC is generally any foreign corporation that is owned more than 50 percent by U.S. shareholders. I.R.C. § 957(a). However, for purposes of applying the rules regarding Subpart F insurance income discussed below, the ownership threshold is reduced to 25 percent. I.R.C. § 957(b). For most situations, U.S. shareholder is defined as a U.S. person that owns at least 10 percent of the voting power of the stock of the foreign corporation. I.R.C. §951(b).
3 Koehring Co. v. U.S., 583 F.2d 313, 317 (7th Cir. 1978).
4 I.R.C. § 952(a)(1). I.R.C. § 953(a)(1) defines "insurance income" as "any income which – (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would [...] be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company."
5 I.R.C. § 954(a).
6 I.R.C. § 954(c).
7 *See* I.R.C. § 953(e)(1)(A) (defining "exempt insurance income"); I.R.C. § 953(e)(3) (defining "qualifying insurance company"); and I.R.C. § 954(i)(2) (defining "qualified insurance income").
8 Pub. L. No. 105-34.
9 I.R.C. §§ 953(e)(10) and 954(h)(9).
10 I.R.C. § 954(b)(3)(B).

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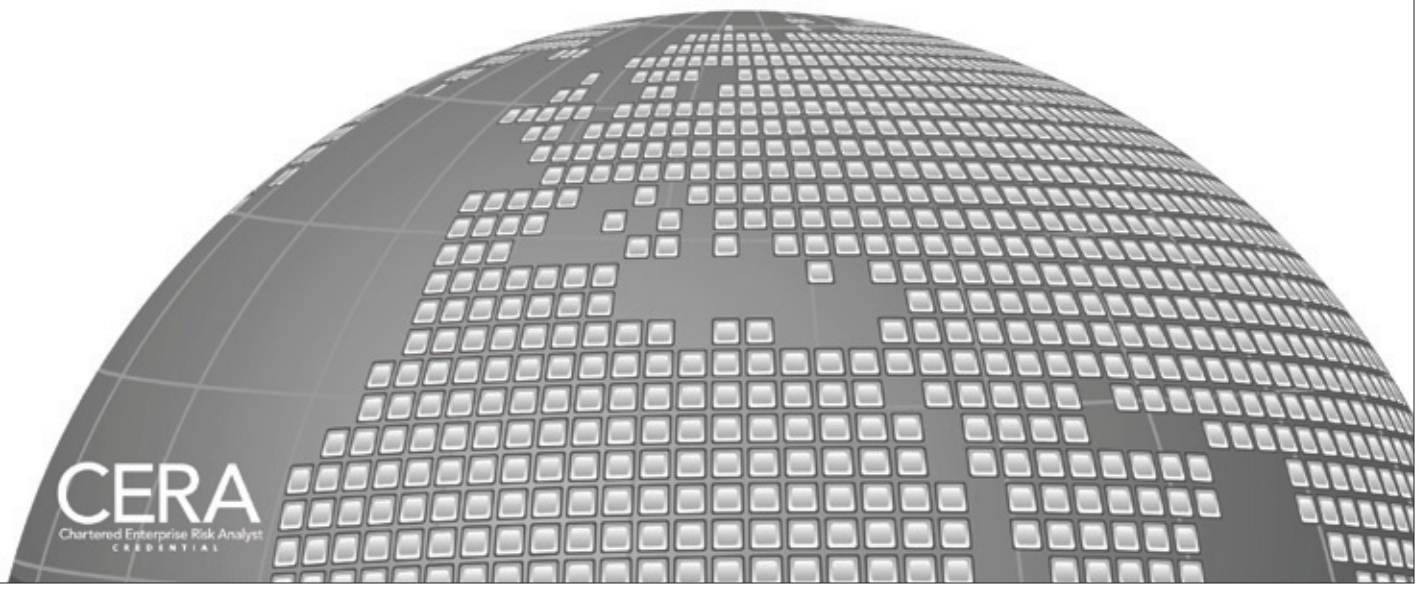

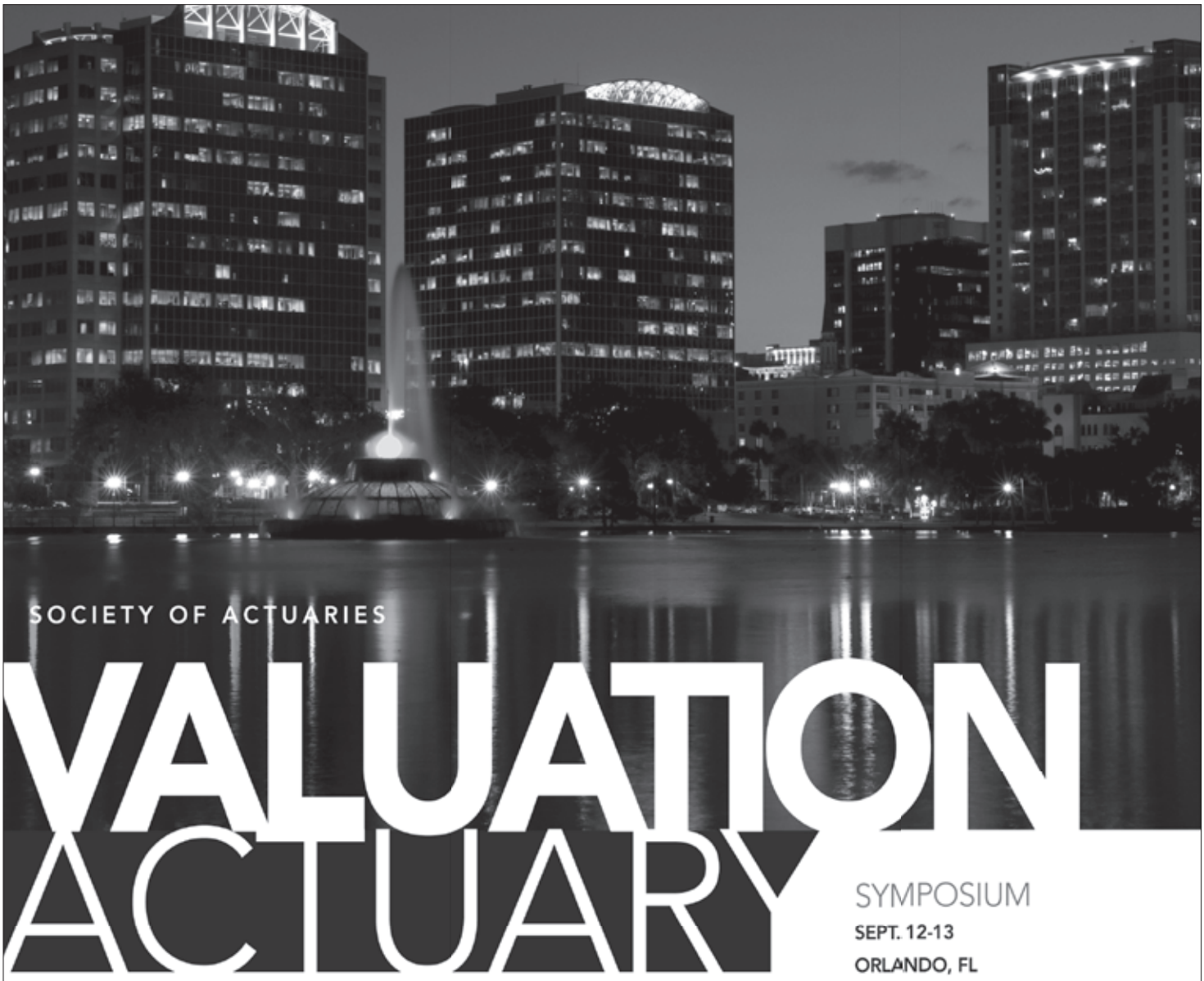

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