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ACLI UPDATE

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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.