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UPDATE IRS ISSUES GUIDANCE REGARDING THE 2 PERCENT DE MINIMIS EXCEPTION UNDER IRC SECTION 162(m)(6)

By Daniel Stringham

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In a recent article titled *IRS Issues Notice 2011-02 in Connection with the New $500,000 Compensation Deduction Limit,* we reviewed Section 162(m)(6) of Internal Revenue Code (the "Code"), its potential impact upon the life insurance industry and a 2 percent de minimis exception from the harsh results associated with this new section of the Code.[1] Specifically, we noted that 162(m)(6) would not apply if certain premiums received from providing health insurance coverage were less than 2 percent of an employer's gross revenues for that taxable year, but that the Internal Revenue Service (IRS) Notice had also not provided a definition of gross revenues for this purpose. As a result, insurers were left to exercise their best judgment in applying the exception. On April 2, 2013, the IRS published Proposed Regulations under Section 162(m)(6) which, among other things, defined gross revenues for this purpose.[2] Unfortunately, as discussed below, the definition in the Proposed Regulations still requires some clarification by the IRS.

BACKGROUND

By way of background, Section 162(m)(6) was added to the Code as part of the Patient Protection and Affordable Care Act, and generally limits the deductibility of any compensation paid by certain health insurers to an individual to $500,000 per year. This provision was enacted to prevent insurance companies, and insurance executives, from profiting when millions of new customers purchased health insurance as a consequence of health care reform. The immediate concern for the life insurance industry was that Section 162(m)(6) could reach beyond traditional health insurance companies and also apply to life insurance companies with legacy health insurance business and to life insurance companies that sell relatively small amounts of health insurance or specialty insurance products. In response to inquiries from the life insurance industry, on Dec. 12, 2010, the IRS issued Notice 2011-02 that provided the 2 percent of gross revenues de minimis exception noted above and also answered many, but not all, of the questions raised by the industry.

DEFINITION OF GROSS REVENUES

The mechanics of the 2 percent de minimis test were briefly addressed when the IRS issued the Proposed Regulations in April 2013. In the Preamble, several paragraphs were dedicated to reviewing comments received about the de minimis exception but nothing was mentioned about the calculation of gross revenues, which would have been the logical place to at least provide some commentary and guidance on this important issue.[3] Instead, and without explanation, the IRS simply proposed a rule within the body of the regulation itself, which reads as follows: "In determining whether premiums constitute less than two percent of gross revenues, the amount of premiums and gross revenues *must be determined in accordance with generally accepted accounting principles*."[4]

It is reasonable to question whether the reference to "generally accepted accounting principles" is intended to be a reference to U.S. GAAP or, given that the terms are not capitalized, simply a requirement to use reasonable accounting principles when determining gross revenues. The answer to this question is critical as the results may be quite different depending upon the product portfolio of the insurance company. For example, if the measure of gross revenue is a GAAP measure, then issuers of annuities are significantly disadvantaged under the 2 percent test. This is the case because, for example, under GAAP a $100 premium for an annuity contract is accounted for primarily as a deposit, whereas statutory and tax accounting principles include the $100 in gross income.[5] As a consequence, an annuity writer (or an insurance company with an annuity business unit) with the same inflow of premiums would have a much lower 2 percent threshold than an issuer of only life insurance contracts, and thus the annuity writer would have a greater likelihood of falling within Section 162(m)(6) of the Code. Presumably, this was not the result intended by the proposed rule.

NEXT STEPS AND REQUEST FOR COMMENTS

At the May 2013 Insurance Tax Seminar of the Federal

Bar Association, an IRS official informally (and publicly) clarified that the reference to generally accepted accounting principles was not meant to refer to a U.S. GAAP measure, but instead was a reference to reasonable accounting principles.[6] While the informal guidance was helpful to the insurance industry, it is important to note that a public statement by an IRS official does not bind the IRS or provide taxpayers with sufficient legal authority to rely upon the statement. As a consequence, and given that the Proposed Regulations requested comments and/or a request for a hearing on the Proposed Regulations, it is expected that the industry will seek further clarification in the final regulations.

END NOTES

1. *See* TAXING TIMES, Vol. 7, Issue 2, May 2011 at page 38.
2. *See* Prop. Treas. Reg. § 1.162-31(b)(4)(iii)(A).
3. *See* the Preamble at Section E, De Minimis Exception.
4. *See id.* at footnote 2 (emphasis added).
5. *See* FASB ASC 944-605-25-4A, ASC 944-605-35-1 & -1A, ASC 944-80-05-1 through 05-3 and ASC 944-80-25-3.
6. *See* statements by Stephen Tackney, IRS deputy associate chief counsel (tax-exempt and government entities), in *Reaction to Health Insurance Compensation Regs Positive Overall, Tax Notes Today* (June 3, 2013).

IS THERE ANOTHER TAX RESERVES SOLUTION FOR PRE-2010 VARIABLE ANNUITIES?

By Peter H. Winslow

Life insurance companies and the Internal Revenue Service (IRS) are continuing to struggle with the tax reserve method to use for variable annuity contracts issued prior to Dec. 31, 2009. Since the adoption of Actuarial Guideline (AG) 43 effective on Dec. 31, 2009, statutory reserves for variable annuity contracts issued on or after Jan. 1, 1981, have been computed using that guideline. In Notice 2010-29,[1] the IRS provided interim guidance on tax reserve issues that arise from AG 43. As to pre-2010 contracts, the IRS Notice states: "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." The IRS determined that this interim guidance for pre-2010 contracts was required by I.R.C. § 807(d)(3), which defines the tax reserve method as CARVM prescribed by the National Association of Insurance Commissioners (NAIC) in effect on the date of the issuance of the contract. Although the NAIC gave AG 43 "retroactive" effect for pre-2010 contracts, the IRS considered AG 43 to represent a change from the NAIC's prior interpretation of CARVM. In such a circumstance, the IRS concluded that the Internal Revenue Code requires the NAIC's interpretation at the date of the contract's issuance to govern.

The problem with the IRS's conclusion is that, in the absence of AG 43, there is no clear NAIC guidance regarding how to interpret CARVM for variable annuity contracts that have guaranteed living benefits (VAGLB) riders. And, the IRS has not provided any additional guidance to supplement Notice 2010-29.

In the absence of IRS guidance, life insurance companies generally have adopted one of two approaches to determine tax reserves for pre-2010 annuity contracts with VAGLB. Some companies use AG 39 to compute tax reserves on the basis that it applied to the contracts at the time they were issued—at least for contracts issued after the 2002 effective date of AG 39. Other companies take a different approach. These companies do not follow AG 39 for several reasons, but primarily because, by its terms, AG 39 (as amended) specified that it would sunset no later than Dec. 30, 2009. Therefore, the argument goes, although AG 39 was prescribed by the NAIC at the date the contracts were issued, it was only prescribed for pre-2010 years. Thereafter, the NAIC specified that other guidance would become applicable. The NAIC guidance that the second group of companies follows is the general provisions of AG 33, as well as by analogy AG 34, which applied to variable annuity contracts with guaranteed minimum death benefits. This second approach has been referred to as the "hybrid method," and details of its application can be found in a TAXING TIMES article that this commentator co-authored.[2]

Each of these solutions has its drawbacks and the IRS (and companies) are having difficulty choosing which approach is better. There is an obvious problem with continuing to use AG 39 which, by its terms, sunsets specifically for those contracts to which it applies. Furthermore, using AG 39 as the tax reserve method for pre-2010 contracts is problematic because the Charge Accumulation portion of the reserve is not an actuarial calculation of CARVM that computes the greatest of the present values of future benefit streams. And, the IRS has consistently resisted permitting stochastically computed

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reserves, such as was required by the asset adequacy portion of AG 39 reserves, from being included in the tax reserve method.

In light of these problems with AG 39, it would seem that the hybrid method would be a more likely approach for the IRS to endorse, but this commentator understands that the IRS is concerned that the hybrid method entails companies making actuarial judgments for which no VAGLB-specific NAIC guidance is available (*e.g.*, the asset drop and recovery assumption). The IRS may be reluctant to endorse a tax reserve method that grants flexibility to companies to determine different levels of tax reserves for comparable contracts.

There is a way out of this dilemma for the IRS because there is another option that has ample support in the statute. This approach is to say that AG 43, in fact, is the proper tax reserve method for pre-2010 contracts. How could the IRS reach this conclusion? Easy. Just follow NAIC guidance at the time the contract was issued as required by I.R.C. § 807(d)(3).

The last sentence under the heading "Purpose" in AG 33 provides as follows:

> While this Actuarial Guideline applies to all annuity contracts subject to CARVM, 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 the Actuarial Guideline.

This sentence in AG 33, coupled with the sunset provision in AG 39, could be interpreted to mean that, at the time a pre-2010 contract subject to AG 33 was issued, the NAIC had prescribed that, if the NAIC ever replaced AG 39, the replacement method would automatically apply for contracts with VAGLB. As a result, when the NAIC adopted AG 43 and made it applicable to pre-2010 contracts, AG 43 became the tax reserve method for pre-2010 contracts under I.R.C. § 807(d)(3) by virtue of AG 33. Because AG 33 was in effect when pre-2010 contracts were issued and contemplated more specific subsequent guidance, AG 43, as the anticipated subsequent guidance, actually was the applicable NAIC method provided for in AG 33 at the time the contract was issued. This possible solution to the pre-2010 contract problem finds additional support in the Sixth Circuit's decision in *American Financial Group v. U.S.*,[3] which concluded that I.R.C. § 807(d) requires deference to NAIC guidance in determining the tax reserve method, if the NAIC guideline is merely a clarification of how CARVM applies to previously issued contracts. Adoption of this position by the IRS presumably would require supplementation of Notice 2010-29, but, after all, the Notice was just interim guidance.

Which is the best answer? Now we have plausible arguments for three tax reserve methods for pre-2010 contracts with VAGLB. Companies and the IRS: Take your pick.

END NOTES

1 2010-15 I.R.B. 547.

2 Peter H. Winslow and Michael LeBoeuf, *How Are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?* 1 TAXING TIMES, Vol. 7, Iss. 2 (May 2011).

3 678 F.3d 422 (6th Cir. 2012).

SUBCHAPTER L: CAN YOU BELIEVE IT?

By Peter H. Winslow

Author's Note:

> *As an original member of the editorial board of, and frequent contributor to,* TAXING TIMES, *I have been pleased with how it has developed. Newsletters work best when they have a mix of articles and regular columns. As of now,* TAXING TIMES *has regular columns from the editor, the chair of the SOA Taxation Section Council, and the American Council of Life Insurers (ACLI). With this edition of* TAXING TIMES, *I am starting what I hope will be a short regular column that is mostly for fun—pointing out quirks in life insurance taxation. I hope readers will enjoy it and that it will encourage others to think about volunteering to start a regular column for future editions of* TAXING TIMES.

Former I.R.C. § 818(c) permitted life insurance companies to elect for tax purposes to convert their life insurance reserves computed on a preliminary term basis to a net level premium basis using either an exact method or an approximate method. The preliminary term reserve revaluation provision was repealed by the Tax Reform Act of 1984. Nevertheless, **I.R.C. § 818(c) is still in effect. Can you believe it?**

Prior to the 1984 Act, stock life insurance companies were required to maintain a policyholders' surplus account that was built up by adding certain tax advantages, which included an untaxed portion of gain from operations, and

certain special deductions for nonparticipating, accident and health, and group life contracts. Technically, these stock company tax benefits were not permanent, but instead under I.R.C. § 815 were subject to tax (the so-called "Phase III tax") when a release of some or all of the policyholders' surplus account occurred. One triggering event under I.R.C. § 815(d)(4) resulted when the policyholders' surplus account exceeded the greater of three limitations, one of which was 15 percent of life insurance reserves at the end of the taxable year. The level of the policyholders' surplus account and the amount of life insurance reserves at year-end used to be closely monitored by stock companies to ensure that the Phase III tax under I.R.C. § 815 would not be triggered.

For a variety of political reasons, I.R.C. § 815 was preserved in the 1984 Act although the policyholders' surplus account was frozen as of Dec. 31, 1983, with no subsequent additions. Current I.R.C. § 815 is somewhat ambiguous, and in certain respects contradictory, in part because I.R.C. § 815(f) incorporates by reference the Phase III tax trigger rules of repealed I.R.C. § 815(d) "as in effect before the enactment of the Tax Reform Act of 1984." What this seems to mean is that to the extent current I.R.C. § 815 can be read to impose a Phase III tax when the policyholders' surplus account exceeds 15 percent of life insurance reserves, for this purpose any life insurance reserves computed on a preliminary term basis should be recomputed to net level reserves under repealed I.R.C. § 818(c) if an election was in place. So, yes, I.R.C. § 818(c) is still in effect.

Does this matter? Not really. In the American Jobs Creation Act of 2004, I.R.C. § 815 was amended so that, for taxable years 2005 and 2006, distributions could be made from policyholders' surplus accounts and not taxed. Most stock life insurance companies took advantage of this rule and no longer have policyholders' surplus accounts that are potentially taxable under I.R.C. § 815. But, a reliable source has told me that he knows of at least one company that still has a policyholders' surplus account. Even though the Phase III tax has little continuing practical effect (except for the inattentive company), I haven't written anything about former I.R.C. § 818(c) in a long time and nostalgia got the better of me. ◀

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