SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

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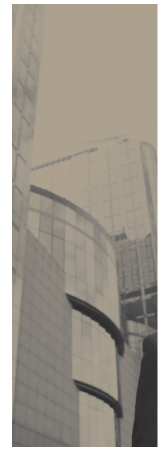

WHAT IS THE TAX RESERVE METHOD "AS OF" THE DATE OF ISSUANCE OF THE CONTRACT?

By Peter H. Winslow

One of the most contentious issues between the Internal Revenue Service (IRS) and life insurance companies relating to tax reserves involves the legal relevance of Actuarial Guidelines (AGs) adopted by the National Association of Insurance Commissioners (NAIC) after a contract was issued. Much has been written in *TAXING TIMES* about these disputes,[1] and much more undoubtedly will be written. Life insurance companies have argued that they are entitled to adjust their tax reserve methods for previously issued contracts to conform to statutory reserves where the methodology or assumptions used to compute statutory reserves have changed to comply with newly issued AGs. This argument usually is made only where the AG methodology is not inconsistent with a prior AG in effect at the time the contract was issued or inconsistent with a uniform interpretation of the Standard Valuation Law (SVL) by a majority of state insurance departments at the time the contract was issued. By contrast, the IRS argues, in effect, that insurance companies must continue to use the same tax reserve method computation initially adopted by the company if it would have been permitted by a majority of states at the time the contract was issued.[2] The IRS makes this argument even when the NAIC makes the AG applicable to contracts issued before the AG was adopted and the AG method would have been a permissible interpretation of CRVM or CARVM at the time the contract was issued.

In *American Financial,*[3] the IRS's position was rejected with respect to AG 33 tax reserves used for contracts issued prior to the effective date of AG 33. The United States District Court for the Southern District of Ohio held that AG 33 was sanctioned by the NAIC as a proper interpretation of CARVM as defined in the SVL for contracts issued before the AG was adopted and, because the SVL had not changed, tax reserves were correctly conformed to AG 33 statutory reserves. As of the time this article was drafted, the *American Financial*

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Taxing TIMES

FROM THE EDITOR
IN THIS ISSUE

By Christian DesRochers

On behalf of the editorial staff, we hope that you enjoy this issue of *Taxing Times*. The process of putting the newsletter together is a team effort involving the Editorial Board, the editors and, of course, the authors, as well as all of the people who work behind the scenes to produce the copy. This edition contains a diverse collection of articles, a few of which I'd like to highlight.

In this issue, Peter Winslow has written an article on CARVM, which continues a discussion of actuarial guidelines (AGs) and their role in defining the tax reserve method, particularly with respect to the interpretation of the phrase "in effect on the date of issuance of the contract." In "What is the Tax Reserve Method "as of" the Date of Issuance of the Contract," Peter describes issues related to AGs that are being litigated in the *American Financial* case, as well as the *CIGNA* case. The two cases, as well as the introduction of AG 43, have focused attention on AGs generally. As companies have moved from AG 39 to AG 43 for statutory reserves, the proper treatment of variable annuity living benefit reserves for contracts in force prior to Dec. 31, 2009 will continue to generate discussion between the Internal Revenue Service (IRS) and the life insurance industry. As decisions are handed down in the litigation it will be interesting to see what, if any, effect they have on the treatment of AGs in defining the tax reserve method.

Sam Mitchell and Peter Winslow provide a summary of issues related to insurance company bad debts. As Sam and Peter point out, the life insurance industry and the IRS have agreed to attempt to resolve the problem through the Industry Issue Resolution (IIR) program. This program attempts to resolve issues that affect a significant number of business taxpayers through the issuance of guidance, generally in the form of a Revenue Ruling or a Revenue Procedure. It is intended to produce a uniform solution to a problem that can be relied upon by both the IRS and taxpayers as a way to resolve what would be frequently disputed or burdensome tax issues. This is one of the first issues for the life insurance industry under the IIR program.

Rick Gelfond and Mary Gillmarten have written an article on the Foreign Account Tax Compliance Act (FATCA), which imposes new reporting and withholding requirements related to foreign individuals and other entities. Under FATCA, U.S. insurers may be required to withhold on payments to non-U.S. payees. Non-U.S. insurers who are the recipients of payments from U.S. entities may also be required to collect additional information from their policyholders. Depending on the ultimate outcome, FATCA has the potential to increase compliance costs for U.S. insurers.

Finally, this issue marks a significant change in the *TAXING TIMES* editorial staff, as we say goodbye to Christine Del Vaglio, who has served as an assistant editor since the very beginning of Taxing Times. On behalf of all of the authors and Editorial Board, and particularly Brian King and I, we'd like to wish Christine all the best, and to thank her for all of her years of service. She will be missed!

If any of our readers have thoughts or comments they would like to share, please let me know.

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FROM THE CHAIR

REFLECTIONS ON THE PAST YEAR

By Steven C. Chamberlin

This is our last issue of 2011 and my last column as section chair. Past council members don't tend to fade away in this section, but continue to contribute as Friends of the Council. Serving on the section council has been a rewarding experience for me and I plan to remain active.

Before passing the torch to next year's chair and our newly elected council members, I'd like to look back at some of our accomplishments over the past year:

- *Taxing Times* continues to be recognized as an important forum for life insurance taxation. Our newsletter has addressed important topics such as the implications of Actuarial Guideline 43 on variable annuity tax reserves, developments in principle-based reserves and International Financial Reporting Standards (IFRS) and how they might impact tax reserves, various Section 7702 issues and a myriad of other issues of interest to life insurance companies and their policyholders.
- What could be more fun than spending a couple days in Orlando in March learning about life insurance tax reserves? That was a popular way to spend spring break as our Tax Reserves Seminar was well-attended. Our section recognizes that many actuaries don't have formal training in this area, and there are always new developments. We'd like this seminar to become a fixture on the SOA calendar every couple of years.
- Our section also sponsored a "What is CARVM?" webinar to discuss actuarial guidelines and their implications for tax reserves. It provided current guidance on tax reserves for in-force variable annuity guaranteed living benefits, Actuarial Guideline 43 implementation issues and current annuity reserve audit issues.
- At the Life and Annuity Symposium, we sponsored a breakfast and three other sessions providing current information with an emphasis on tax issues of interest to product actuaries.
- At the Valuation Actuary Symposium, we are also sponsoring a breakfast and a session on current federal income tax topics for life insurers. After the symposium, we are sponsoring a seminar on "U.S. Federal Income Taxation of Life Insurance Companies." It is designed to provide an overview of the key tax issues faced by life insurers and insight into the computation of taxable income of life insurers.
- We are sponsoring four sessions at next month's annual meeting in Chicago. Be sure to join us for an "Introduction to Company Tax," "Health Tax Reserve Issues," "Introduction to Life Insurance Product Tax Issues" and "Current Developments in Life Insurance Federal Income Tax."
- Our section organized the Necessary Premium Task Force last year. This group created a survey designed to gather information on how companies' administrative systems are currently applying the necessary premium test. Results of that survey will be presented at our breakfast session at the annual meeting.

I'd like to thank the other council members for their hard work over the past year. In addition, I greatly appreciate the contributions of the newsletter authors and editors and the speakers at sessions we have sponsored in the past year. Our affiliate members have provided a lot of that content, and we benefit greatly from their accounting and legal perspectives. I'd also like to thank our SOA staff partners, Meg Weber and Christy Cook, for their support in the past year.

Last, but certainly not least, I'd like to thank Jim Reiskytl for giving me a push when I needed one three years ago. I was unsuccessful the first two times that I ran for this council. I was ready to give up at that point, but Jim convinced me to give it another try. I have gained a lot from this experience and I would encourage others to contribute to our profession any way that they can. You truly do get more out of it than you put in.

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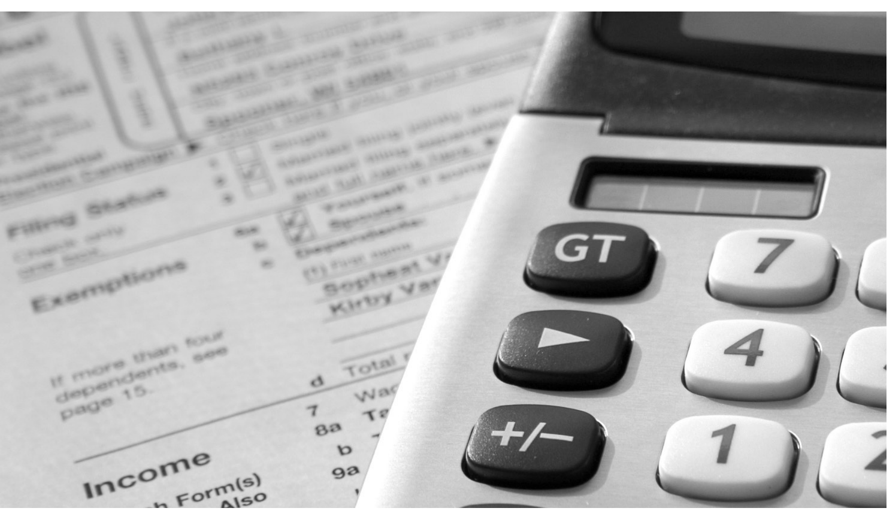
case was pending on appeal in the Sixth Circuit. Another case, pending in the Tax Court, introduces a new wrinkle into this controversy. In *CIGNA Corp.*,[4] the issue is whether CIGNA properly computed its tax reserves for variable annuity guaranteed minimum death benefits (GMDB) under AG 34. The twist is: the tax reserves at issue were for risks arising under reinsurance contracts and CIGNA argues that different tax rules apply.

BASIC TAX RESERVE RULES

Under I.R.C. § 807(d), life insurance reserves generally are required to be computed in accordance with the tax reserve method prescribed by the NAIC in effect on the date of issuance of the contract. The tax reserve method for life insurance contracts is CRVM for contracts covered by CRVM, and for annuity contracts it is CARVM for contracts covered by CARVM. For contracts not covered by CRVM or CARVM, the reserve method prescribed by the NAIC as of the date of contract issuance must be used, or, if no method has been prescribed, a reserve method consistent with whichever of the prescribed methods is most appropriate must be used. After the tax reserve is computed, using the federally prescribed interest rate and prevailing state mortality table, the reserve is then capped by statutory reserves and floored by the net surrender value determined on a contract-by-contract basis.

Where there are state-by-state variations in the interpretation of CRVM or CARVM on the issue date of the contract, the legislative history offers guidance as to how to interpret CRVM and CARVM for tax purposes.[5] First, the taxpayer is required to use the method prescribed by the NAIC in effect on the date of issuance of a contract, and take into account any factors recommended by the NAIC for such contracts. The factors referred to in the legislative history are those recommended by the NAIC in model regulations or AGs issued by the NAIC. Second, where no such factors are recommended, or for contracts issued prior to the NAIC's adoption of guidance, taxpayers are to look to the prevailing state interpretation of the SVL, *i.e.,* the interpretation that has been adopted by at least 26 states, if one exists. The 26-state rule from the legislative history is not found in I.R.C. § 807(d), which merely defers to the reserve method prescribed by the NAIC. This legislative history can be reconciled with the statute by interpreting it to mean that if 26 states have adopted a uniform interpretation of the SVL, then the NAIC, through a majority of its members, has tacitly prescribed an interpretation on the date the contract was issued.



Finally, the legislative history states that, in general, life insurance reserves are computed by starting with the assumptions made for statutory reserves and then making the adjustments required by I.R.C. § 807(d). This suggests that, absent an NAIC guideline or a uniform prevailing interpretation of the states, the tax reserve method should follow the interpretation of the SVL used by the taxpayer for its statutory reserves, as long as that was a permissible interpretation at the time the contract was issued.[6] Using the statutory reserve to fill in any gaps for tax reserves not specifically dictated by I.R.C. § 807(d) is consistent with the basic accounting method rule in I.R.C. § 811(a), which provides that when accrual accounting is not applicable (*e.g.,* life insurance reserves), all computations shall be made in a manner consistent with the NAIC Annual Statement.[7]

IRS/TAXPAYER CONFLICTS

The disputes between the IRS and life insurance companies relating to CRVM or CARVM in effect on the date the contract was issued are usually couched in terms of whether an AG should be given retroactive effect. This characterization of the disputes is misleading. The nub of the controversy relates to how to interpret the legislative history when there was no specific NAIC guidance as to how to apply the SVL at the time the contract was issued. Specifically, the IRS and taxpayers do not agree on what it means to have a majority view of the states and when statutory reserve assumptions should be used to fill in gaps in NAIC guidance.

The IRS's position is set forth in TAM 200448046 (Aug. 30, 2004). In the TAM the issue was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with GMDB that were issued before the adoption of AG 34. For statutory purposes, the taxpayer used a method required by the Connecticut Insurance Department which, for purposes of computing statutory reserves, required an assumption of a one-third drop in asset values. The Connecticut asset-drop assumption was not required by any other state as of the issue date of the contracts and resulted in greater reserves than were required under the AG 34 method that subsequently was adopted.

The IRS concluded that the taxpayer could not use the Connecticut interpretation of CARVM because at least 26 states permitted smaller reserves for the GMDB. The TAM implicitly concluded that a prevailing view of the states can be gleaned from passive acceptance by state regulators of CARVM interpretations made by companies in filing their Annual Statements. Thus, even though there was no uniform prevailing state interpretation of CARVM with respect to the treatment of the GMDB, and even though a majority of states may have viewed several interpretations of CARVM as permissible, the TAM concluded that reserves must be computed using the method that yields the smallest reserve permitted by at least 26 states.

Life insurance companies have disagreed with this IRS position, and have pointed out that it is in conflict with the legislative history's discussion of the permitted use of either continuous or curtate functions in computing CRVM reserves. At the time of the 1984 Act, a majority of states permitted either assumption, yet the legislative history suggests that the assumption used for statutory reserves governed regardless of which assumption yielded the smaller reserves. In other words, in determining whether there is a prevailing state interpretation of the SVL, the focus is supposed to be on whether a majority of states has adopted a uniform view as to what is the proper interpretation of CRVM or CARVM, and not on whether there is a permissible interpretation that may yield a smaller reserve that at least 26 states would have allowed.

CIGNA CASE

The *CIGNA* case involves tax reserves for GMDB computed under AG 34 for tax years 2003 and 2004 attributable to risks under variable annuity contracts issued prior to the NAIC's adoption of AG 34. In a motion for summary judgment, the IRS made the argument that AG 34 cannot be applied retroactively to variable annuity contracts issued before its adoption by the NAIC. Although the IRS's briefs are not clear on this point, it initially contended that CIGNA is required to use the same tax reserve method it adopted when it initially established statutory reserves because that method was permitted to be used by a majority of state insurance departments at that time.

The IRS concluded that the taxpayer could not use the Connecticut interpretation of CARVM because at least 26 states permitted smaller reserves for the GMDB.

CIGNA's response to the motion for summary judgment sidestepped the IRS's argument. CIGNA pointed out that it had reinsured risks from another insurer and that, as a technical matter, CARVM in the SVL does not apply to reserves held under reinsurance contracts. In such a case, the applicable Code provision is I.R.C. § 807(d)(3)(iv) which provides that, for contracts not covered by CRVM or CARVM, the reserve method is the method prescribed by the NAIC "as of" the date of issuance of the contract. By its terms, AG 34 applies to reinsured risks under variable annuities with GMDB even though CARVM technically does not apply. Because the NAIC makes AG 34 applicable to all contracts issued on or after Jan. 1, 1981, CIGNA argues that AG 34 is the NAIC-prescribed method "as of" that date. Thus, it appears that CIGNA contends that, if the IRS's "retroactivity" argument has any merit, there is a material distinction between the NAIC method "in effect on" the issue date of a contract for a contract covered by CARVM and the NAIC method "as of" that date for a contract that is not covered by CARVM. That is, even if the IRS is correct that AG 34 cannot be applied for tax purposes retroactively to a direct writer's reserves for annuity contracts issued before AG 34 became effective, CIGNA nevertheless was correct in applying AG 34 because, by its terms, AG 34 was effective retroactively for reinsurance contracts "as of" the dates they were entered into.

In a subsequent court filing, the IRS conceded that CIGNA's AG 34 reserves yielded a reasonable approximation of the smallest reserves permitted by 26 states. Yet, at the time of drafting this article, the case still was scheduled to go to trial because the IRS refused to concede the legal point asserted by

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CIGNA that AG 34 could apply for tax purposes to contracts issued before its adoption by the NAIC.

CONCLUSION

Regardless of the outcome of the legal issue raised by CIGNA in its response to the IRS's motion for summary judgment, CIGNA should prevail in the case. AG 34 was a permissible interpretation of the SVL for reinsurers of variable annuities for risks "in effect on" and risks "as of" the dates both the reinsurance contracts were entered into and the underlying annuities were issued. And, AG 34 was not contrary to prior NAIC guidance or a majority-of-states uniform interpretation of the SVL. Consequently, as I.R.C. § 811(a) and the legislative history provide, the statutory reserve method (AG 34 reserves) should be followed for tax purposes.

By Order dated April 5, 2011, the *CIGNA* court rejected the IRS's motion for summary judgment without ruling on the legal issues, saying that there are disputed issues of facts. By another Order dated July 27, 2011, the court refused to accept the IRS's limited concession that AG 34 reserves are a reasonable approximation of the reserves that would result under the IRS's version of the 26-state rule. The case has been scheduled for trial in September 2011. Consequently, we may have to wait some time for the Tax Court's decision.

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END NOTES

1 *See* Bush, IRS Rules on American Financial, 6 Taxing Times 10 (Sept. 2010); Winslow, Common Myths in Interpreting the Company Tax Provisions of the 1984 Act, 5 Taxing Times 50 (Sept. 2009); Winslow, IRS's Position on Retroactivity of Actuarial Guidelines to be Tested in Court, 4 Taxing Times 40 (Feb. 2008); Winslow and Hotine, IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date, 1 Taxing Times 15 (Sept. 2005).

2 TAM 200448046 (Nov. 26, 2004).

3 American Financial Group v. United States, 726 F. Supp. 2d 802 (S.D. Ohio 2010), appeal docketed, No. 10-3991 (6th Cir. Aug. 17, 2010).

4 CIGNA Corp. v. Commissioner, No. 13645-09 (T.C. filed Jun. 4, 2009).

5 Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 601 (Comm. Print 1984) ("1984 Blue Book").

6 TAM 200108002 (Oct. 24, 2000).

7 *See* Commissioner v. Standard Life & Accident Ins. Co., 433 U.S. 148 (1977).

IRS RULING CONFIRMS EXCHANGE OF COLI ON FORMER EMPLOYEES TRIGGERS LOSS OF INTEREST DEDUCTIONS

By John T. Adney and Bryan W. Keene

On March 5, 2011, the Internal Revenue Service (IRS) issued Revenue Ruling 2011-9,[1] which addresses the implications under section 264(f) of a tax-free exchange of corporate-owned life insurance (COLI) contracts.[2] The ruling concludes that such an exchange will result in a loss of the contract's exception to section 264(f)(1) for employee coverage if, at the time of the exchange, the insured is no longer an employee, but rather is a former or "inactive" employee, of the corporate policyholder. This confirms in published guidance an IRS position that has been well-known since the IRS first expressed it in a 2006 private letter ruling.[3]

Section 264(f)(1) imposes restrictions on the deductibility of interest expenses by a business taxpayer that owns or benefits from life insurance contracts, *i.e.*, the typical COLI or bank-owned life insurance (BOLI) contract. Section 264(f)(4)(A) provides an exception to this rule for a contract owned by an entity engaged in a trade or business if the contract covers a single insured who falls within a specified class (a "permitted insured"). A permitted insured is an individual who, at the time first covered by the contract, is a 20-percent owner of the entity or is an officer, director, or employee of the trade or business. Thus, the exception to the normal interest expense limitation rule is sometimes called the "employee coverage exception." The new ruling concludes that, for purposes of this exception, an individual is a permitted insured "at the time first covered" by the contract only if he or she holds that status when the contract is issued, whether in a new purchase or in a subsequent exchange. As a result, the ruling also concludes that if a contract that met the employee coverage exception when it was first purchased is subsequently exchanged for a new contract at a time when the insured is a former employee, the employee coverage exception will be lost for the contract going forward.

The ruling reaches these conclusions in the context of two hypothetical situations involving tax-free exchanges of COLI contracts. In both situations, a corporate taxpayer has substantial indebtedness (unrelated to life insurance purchases) on which it incurs interest expense. The taxpayer purchases a life insurance contract covering the life of an individual who, at the time of purchase, is an employee of the taxpayer. The taxpayer then exchanges the contract for a new one in a section 1035 exchange. The new contract has the same death benefit as the old and covers the life of the same individual. In the first situation, the insured is still the taxpayer's employee at the time of the exchange. In the second situation, the insured is no longer an employee when the exchange occurs.[4]

The ruling states that in both situations the employee coverage exception applies before the exchange, because the insured was the taxpayer's employee when the taxpayer originally purchased the contract. Likewise, the ruling states that in the first situation the exception applies to the new contract issued in the exchange because the insured was still the taxpayer's employee when the new contract was issued. In the second situation, however, the insured was not the taxpayer's employee when the new contract was issued in the exchange, so the ruling concludes that the employee coverage exception does not apply to the new contract in that situation.

In support of this conclusion, the ruling cites to various authorities reflecting the view that a life insurance contract received in exchange for an existing life insurance contract is treated as a new contract issued on the date of the exchange. For example, the ruling observes that such treatment of exchanges generally applies "for purposes of testing [a] contract's qualification as a life insurance contract under [section] 7702."[5] Likewise, the ruling observes that a contract received in an exchange is treated as a new contract for purposes of applying the 7-pay test of section 7702A(b) to determine whether the contract is a modified endowment contract.[6]

The ruling also recognizes that, in some cases, the tax attributes of a life

The new ruling concludes that, for purposes of this exception, an individual is a permitted insured "at the time first covered" by the contract only if he or she holds that status when the contract is issued, whether in a new purchase or in a subsequent exchange.

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insurance contract may carry over to a new contract received in an exchange. The ruling further states, however, that such carryover treatment is limited to situations where Congress has specifically allowed it. For example, the ruling states that carryover treatment for exchanges is allowed for purposes of the effective date of section 101(j) (the so-called "COLI best practices" rules),[7] as well as for purposes of sections 72(q)(2)(I) and (u)(4) (defining an "immediate annuity").[8] Absent a similar directive by Congress for purposes of section 264(f)(4)(A), the IRS treated the exchange as resulting in a new contract with a new issue date for purposes of that section.

While the ruling addresses only an actual exchange of one contract for another, the same conclusion presumably would apply if a deemed exchange were to arise. In that regard, in some cases a material change in existing property will result in a deemed exchange (and, hence, "new contract" treatment in the case of life insurance) for federal income tax purposes even if no actual exchange of property occurs.[9] In the life insurance context, a "material change" in a life insurance contract generally will result in a deemed exchange.[10] For example, the legislative history of section 7702 discusses the treatment of exchanged contracts as new contracts, and goes on to state that:

> a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change.[11]

The potential implication of this language is that a change in an existing contract will be considered to result in an exchange if that change is made to, *inter alia*, the rate or rates of interest guaranteed on issuance of the contract, and that such a deemed exchange will result in the contract being treated as newly issued on the date of the exchange for purposes of section 7702. If the IRS were to extend this view to section 264(f)(4)(A), which it presumably would base on the interpretation it adopted in Rev. Rul. 2011-9 and the lack of any contrary congressional directive, then the "time first covered" requirement of the employee coverage exception would seem to apply anew as of the date of the material change, just as it applies anew in the context of actual exchanges according to the ruling.

As indicated above, the position that the IRS adopts in Revenue Ruling 2011-9 with respect to actual exchanges was first stated in a private letter ruling in 2006.[12] As a result, the interpretation should not come as a surprise to anyone. What the published guidance does, however, is to state the position in a form that applies to all taxpayers, whereas a private letter ruling applies only to the particular taxpayer to which it is issued. Given that the IRS position is now clearly stated in published guidance, any COLI or BOLI policyholders who have taken a contrary position in the past may need to amend their tax returns and adjust their returns going forward, since the new ruling is an interpretation of existing law and the IRS did not limit its effect to prospective tax years or transactions.

END NOTES

1. 2011-12 I.R.B. 554.
2. Each reference to a "section" is to a section of the Internal Revenue Code of 1986, as amended (the "Code").
3. PLR 200627021 (July 7, 2006).
4. Although not mentioned in the ruling, the second situation assumes that state insurable interest laws are satisfied with respect to the coverage on the former employee's life following the exchange. The authors' understanding is that this assumption would be true only in certain states, *e.g.*, Georgia.
5. The ruling cites to S. Rep. No. 98-169, at 579 (1984) (the "DEFRA Senate Report"), and section 5.01 of Notice 2006-95, 2006-2 C.B. 848, for this proposition.
6. The ruling cites H.R. Rep. No. 100-1104, at 98 (1988) for this proposition.

END NOTES CONT.

[7] Despite this generous grandfathering rule under section 101(j), the IRS has taken a very narrow view in enforcing it by stating in published guidance that any "material change" to a contract involved in a section 1035 exchange (other than changing the issuer) will result in a loss of grandfathering under section 101(j). *See* Q&A-15 of Notice 2009-48, 2009-24 I.R.B. 1085. *See* also John T. Adney and Bryan W. Keene, "Guidance Released on COLI Best Practices," *Taxing Times*, vol. 5, issue 3, at 37 (Sept. 2009).

[8] *See* Rev. Rul. 92-95, 1992-2 C.B. 43. For purposes of sections 72(q)(2)(I) and (u)(4), an "immediate annuity" is defined, in relevant part, as a contract under which the annuity starting date is no more than one year from the "date of the purchase of the annuity." Rev. Rul. 92-95 states that for this purpose the "date of purchase" of a contract received in a section 1035 exchange is the same "date of purchase" as the contract being exchanged. This interpretation was necessary to enforce the intent of the relevant Code sections; otherwise, a deferred annuity with considerable tax-deferred inside buildup could be exchanged for a payout annuity and qualify as an immediate annuity. The ruling cites the legislative history of section 72(q) in support of this interpretation.

[9] The Supreme Court has viewed properties as "different" in a sense that is "material" to the Code if the properties' respective legal entitlements were different in kind or extent. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 565 (1991).

[10] *See, e.g.*, TAM 9347005 (Aug. 10, 1993) (concluding that a section 1035 exchange occurred where policyholders accepted an offer by a life insurance company to issue an endorsement that would permanently increase the minimum interest rate guaranteed under the contract, thus effecting a material change in the terms of the contract).

[11] DEFRA Senate Report, *supra* note 5. *See also* H.R. Conf. Rep. No. 98-861, at 1076 (1984) (stating that the conference report follows the DEFRA Senate Report); Staff of the J. Comm. on Tax=n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 656 (J. Comm. Print 1984) (same language as DEFRA Senate Report).

[12] PLR 200627021 (July 7, 2006).

FATCA AND INSURANCE

FUNDAMENTAL QUESTIONS REMAIN UNANSWERED AS COMPLIANCE DEADLINE APPROACHES

*By Frederic J. Gelfond and Mary M. Gillmarten**

Doctor: *I think you might have a FATCA. Please meet me at the hospital.*
Patient: *That sounds serious. What is it?*
Doctor: *It is a large building with beds in it.*
Patient: *No, what's a FATCA? And how do I know if I have it?*
Doctor: *Kinda' hard to explain. But, we are going to have to probe around a bit. There are a lot of areas we need to look into.*
Patient: *Will it hurt?*
Doctor: *Probably.*
Patient: *Surely you can't be serious about all this. I have a business to run.*
Doctor: *Hopefully, getting it under control will not be too expensive. And please, don't call me Shirley!*
Patient: *Does insurance cover FATCA?*
Doctor: *It should, but you ask the wrong thing. The real question is whether FATCA should cover insurance!*

INTRODUCTION

In March 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act of 2010[1] ("HIRE"), section 501(a) of which added a new chapter to the Internal Revenue Code ("chapter 4").[2] The purpose of chapter 4 is to prevent U.S. persons from evading U.S. tax by holding income-producing assets through (1) accounts in foreign financial institutions ("FFIs") or (2) through other foreign entities (non-financial foreign entities, or "NFFEs)".[3] The law does so by imposing new withholding tax requirements on "withholdable payments" made to FFIs by U.S. persons, and expanding the information reporting requirements imposed on FFIs with respect to certain "U.S. accounts,"[4] and by imposing withholding, documentation and reporting requirements relating to certain payments made to NFFEs.

There are, however, certain exceptions for FFIs that enter into agreements ("FFI Agreements") with the IRS to identify and report on their "U.S. accounts," and for NFFEs that provide information about their "substantial U.S. owners." In order to avoid the new withholding requirements, those foreign entities subject to the new withholding regime will have to satisfy the significant reporting and documentation requirements in the new chapter 4.

With a Jan. 1, 2013 effective date, the impact of FATCA has been felt globally, as companies located around the world are seeking to understand and prepare for the potentially significant compliance burdens it could involve. In many cases, implementation of FATCA will necessitate the development of major new systems, processes and protocols in order to capture and report the required information. This is particularly true for those companies whose situations are complicated by multiple locations, businesses and business types.

For the insurance industry specifically, this means that U.S. insurers may be required to withhold on payments to non-U.S. payees, and non-U.S. insurers who are the recipients of payments from U.S. entities may be required to collect information from their policyholders that is not only difficult to receive, but which may also be impermissible to request in certain jurisdictions.

There is no official legislative history to FATCA, but there is a Joint Committee Explanation from which taxpayers and the government can take guidance with respect to these significant and new requirements. Treasury and the Internal Revenue Service ("IRS") have indicated an intention to issue prompt and significant guidance to assist those entities subject to the various withholding and reporting rules to enable them to come into compliance prior to the effective date. Foreign financial entities subject to the rules of FATCA, however, have generally found small comfort in these promises by Treasury and the IRS. Several FFIs, domestic entities that may be withholding agents under FATCA, industry groups, and even some foreign governments have submitted thoughtful and practical comments to Treasury and the IRS regarding the effective date and applicability of the FATCA provisions to specific financial interests.

Among the comments sent to Treasury and the IRS are several from insurance companies, both domestic and foreign, insurance associations and governmental groups. These comments have raised several issues from the essential clarification of who exactly qualifies as an FFI and what qualifies as a "U.S. account," to effective dates and exclusion provisions specific to the insurance industry, as well as broader issues of the compliance burden being imposed vis-à-vis the potential for tax evasion.

To its credit, the Treasury and IRS have issued two notices providing interpretative guidance on FATCA, Notices 2010-60 and 2011-34. [Author's Note: Notice 2011-53, providing some transitional guidance, was released subsequent to the drafting of this article.] Many questions remain, however, with respect to the scope and implementation of the reporting, documentation and withholding rules and both domestic and foreign entities, associations and governmental groups continue to submit comments in response to the notices.

Immediately following is an overview of the some of the basic provisions of FATCA and the initial guidance released by Treasury and the IRS. The article then highlights some of the concerns expressed by the insurance industry through comment letters, and some of the key questions on which the industry is awaiting guidance.

FATCA—OVERVIEW OF BASIC PROVISIONS AND INITIAL GUIDANCE

FATCA imposes a broad expansion of reporting, documentation and withholding rules in order to obtain information about foreign accounts maintained by U.S. persons and prevent perceived tax evasion by those U.S. persons. Section 1471 imposes a mandatory 30 percent withholding tax on "withholdable payments"[5] made to an FFI unless the FFI enters into, and complies with, an agreement ("FFI Agreement") with Treasury.

This provision is a marked change from prior law in that it imposes withholding requirements on amounts that previously were specifically *not* required to be withheld on such as portfolio interest.[6] Section 1471(b) describes the requirements of an FFI Agreement between Treasury and any FFI. The FFI must agree to:

(1) gather certain information about account holders of each account maintained by the FFI as is necessary to determine which (if any) accounts are U.S. accounts;
(2) comply with such verification and due diligence procedures as the Secretary may require with respect to the identification of U.S. accounts;
(3) report on an annual basis specific information with respect to all U.S. accounts identified;
(4) deduct and withhold 30 percent of any passthru payment made to a "recalcitrant account holder" and payments made to an FFI that has made an election to be withheld upon;[7]
(5) comply with requests by the Secretary of the Treasury for additional information with respect to any U.S. accounts; and
(6) in cases where foreign law precludes the reporting of any information required by these provisions, the FFI must agree to attempt to obtain a valid and effective waiver of such law from each holder of a U.S. account, and if a waiver is not obtained within a reasonable period of time, to close any non-waivered U.S. accounts.

Section 1471(b)(2) provides that certain FFIs may be treated as meeting the requirements of the FATCA provisions if such FFI complies with procedures prescribed by the Secretary to ensure that such FFI does not maintain U.S. accounts, and if such FFI meets other requirements as the Secretary may prescribe with respect to accounts of other FFIs maintained by such FFI; or such FFI is a member of a class of institutions with respect to which the Secretary has determined that the application of section 1471 is not necessary to carry out the purposes of the section.

Section 1471(c) provides the information FFIs seeking to avoid the withholding requirement must report on U.S. accounts. This information includes the name, address and taxpayer identification number of each account holder that is a specified U.S. person and in the case of a U.S. foreign-owned entity that is an account holder, the name, address and taxpayer identification number of each "substantial United States owner" of such entity. The FFI must also provide the account number of any U.S. accounts, the account balance or value (determined at such time and in such manner as the Secretary may provide), and, except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide). If this seems burdensome, the statute provides an election to be subject to the same reporting requirements as U.S. financial institutions in certain circumstances.

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Section 1472 of the Code imposes a mandatory 30 percent withholding tax on "withholdable payments" made to an NFFE unless the NFFE certifies that it has no "substantial U.S. owners" or provides information about those U.S. owners. This legislation applies to all FFIs and NFFEs that receive withholdable payments (discussed below) and do not meet the reporting requirements of section 1471(b) and (c) or the waiver or exception requirements of section 1472(b) and (c).

NOTICE 2010-60

On Aug. 27, 2010, Treasury and the IRS issued Notice 2010-60,[8] providing initial guidance on sections 1471–1474, eagerly anticipated by U.S. payors as well as affected foreign payees. Notice 2010-60 explains in detail the terms that will be imposed by FFI Agreements and the types of foreign entities that can receive payments without chapter 4 withholding. The Notice also states that, in future guidance, the Treasury and IRS intend to publish a draft FFI Agreement and draft information reporting and certification forms. In addition to guiding foreign entities through the process of deciding whether or not they must enter FFI Agreements in order to avoid chapter 4 withholding, and understanding what such an agreement entails, the notice provides guidance for U.S. financial institutions ("USFIs") to determine whether or not they are free to refrain from withholding on withholdable payments.

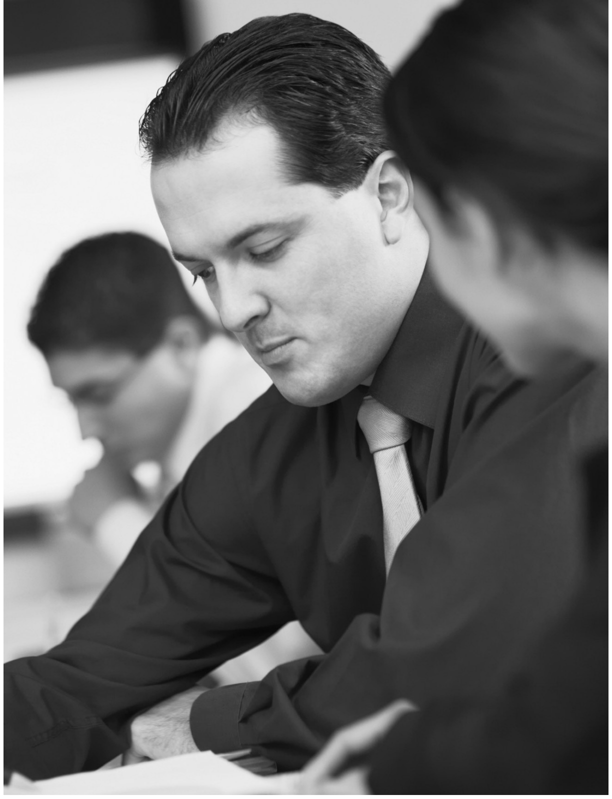
For purposes of this article, the dispositive points of Notice 2010-60 are those specifically addressing insurance companies. The notice points out that the definition of financial institution in section 1471(d)(5)[9] is broad enough to include certain insurance companies, and that the statute grants the Secretary regulatory authority to exclude or include insurance companies and certain products sold by insurance companies within the definition of "financial institution" and "financial account." Treasury and the IRS do not view the issuance of insurance or reinsurance contracts without cash value as implicating the tax evasion concerns of chapter 4. The notice states that Treasury and the IRS intend to issue regulations treating entities whose business consists solely of issuing such contracts as non-financial institutions for purposes of FATCA. This appears to let nonlife insurance companies and life insurance companies that only issue term life policies off the hook for the withholding and compliance requirements.

Notice 2010-60 distinguishes insurance contracts that have a cash value associated with the contract such as annuity contracts that frequently combine insurance protection with an investment component, and identifies such contracts as possibly presenting the risk of U.S. tax evasion that chapter 4 is designed to prevent. The notice does not provide guidance, but rather requested comments.

Notice 2010-60 also addresses retirement plans, which may be held by insurance companies. The notice states that pursuant to section 1471(f), withholding does not apply to any payment to the extent that the beneficial owner of such payment is part of a class of persons identified by the Secretary as posing a low risk of tax evasion. Although a retirement plan may qualify as a financial institution under the broad definition in chapter 4, Treasury and the IRS intend to issue guidance providing that certain foreign retirement plans pose a low risk of tax evasion for chapter 4 purposes, and therefore payments beneficially owned by such retirement plans will be exempt from withholding. The notice provides further guidance stating that a foreign retirement plan will be identified as posing a low risk of tax evasion only if the retirement plan (1) qualifies as a retirement plan under the law of the country in which it is established, (2) is sponsored by a foreign employer, (3) does not allow U.S. participants or beneficiaries other than employees that worked for the foreign employer in the country in which such retirement plan is established during the period in which benefits accrued. The notice then requests comments on the definition of a retirement plan for this purpose and on how such a plan could appropriately identify or document itself to a withholding agent to verify its compliance with any such definitional requirements.

Notice 2010-60 also deals with U.S. branches of FFIs and controlled foreign corporations, requesting comments on basically everything of interest to affected taxpayers.

Notice 2011-34 provides modified procedures for a participating FFI to identify U.S. accounts among its preexisting individual accounts and describes a new procedure for participating FFIs to certify their completion of the requirements for determining the status of their preexisting individual accounts, with a strong emphasis on private banking and the FFI Agreements to come; and how to identify U.S. accounts among existing accounts. These procedures are detailed and exhaustive and the notice requests comments concerning whether other FFIs, and **in particular insurance companies,** should perform procedures similar to those described with respect to holders of preexisting individual accounts, including private placement life insurance.



TAXPAYER, INDUSTRY AND GOVERNMENTAL COMMENTS

Property and Casualty Insurance

The insurance industry as a whole was forthcoming with comments after the promulgation of Notice 2010-60. These comments requested clarification of the definition of an FFI, noting that property and casualty insurance companies do not generally hold financial assets for the accounts of others, and that, generally, investments supporting contracts are owned by the insurer and not its policyholders. Other comments note that property and casualty insurers have occasion to make non-claim payments to their policyholders, but that none of these situations should be considered as holding financial assets for the accounts of others. These occasions include property and casualty contracts with return premium provisions or retrospective rating provisions; payments to policyholders due to commutations of contracts; and the payment of policyholder dividends or similar items. Commentators pointed out that none of these situations give rise to opportunity for tax evasion as contemplated by chapter 4.

Life Insurance, Annuities and Retirement Plans

Some life insurance industry comments argue that all life insurance should be exempted from the definition of financial institution because life insurance offers protection against uncertain events such as death or disability; but commend Treasury and the IRS for recognizing in Notice 2010-60, that at least those life contracts without a cash value should be excluded from the withholding and reporting requirements. Non-U.S. commentators raised several issues regarding the unattractiveness of their life products to U.S. policyholders due to the tax and regulatory rules of the company's country of incorporation and the low risk of using a life insurance product for tax evasion purposes due to the limitations on withdrawals, loans and other means of effectively accessing cash value. Other commentators recommended that contracts existing as of Dec. 31, 2012 be excluded from the definition of financial account.

These commentators point out, as do all of the non-U.S. commentators generally, that the information gathering and reporting requirements are onerous, and particularly so for the insurance industry. Unlike the banking industry, insurance companies do not often have frequent contact with their policyholders. In fact, several life insurance products are single premium products and the insurer may not have current information on the policyholder. They suggest, therefore, that the insurance industry needs additional time to come into compliance. (Generally, in the case of life insurance, it is the policyholder's beneficiary who seeks out the insurance company in the event of death to seek death benefits, not the insurance company that goes out looking for an opportunity to pay, especially when the premiums are all paid up on a policy.) As one commentator pointed out,

> [c]ompliance with the search requirements would be extraordinarily difficult, costly, and, in some cases, almost impossible, requiring a manual search of files that long preceded any anti-money laundering or know-your-customer rules. Insurance companies simply have not had the same data collection requirements and procedures as banks have had and cannot comply in the same manner as banks with respect to existing contracts.[10]

An additional impediment to timely compliance by the insurance industry is the issue of local privacy laws where insurance companies are resident. For example, the EU Data Protection Directive of 1995 (EU Directive) required member states to enact local laws providing a harmonized level of data protection among members. Under the EU Directive, the United States is considered as failing to offer an adequate level of data protection. However, a self-certification safe harbor system was established shortly after the adoption of the EU Directive to permit the transfer of data from the EU to a U.S. company that self-certified itself as a safe harbor entity. The consequence is that insurers in EU member states may be prohibited by law from providing the information required by chapter 4 absent the intended recipient agreeing to be a safe harbor entity. Chapter 4 provides an opportunity for such

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companies to obtain a waiver from local data and information protection laws, but the same issues with respect to timeliness arise as well as questions of the waivers being provided under duress, which would render the waivers invalid under the EU Directive. Several commentators noted that a later effective date would provide time for non-U.S. insurers to work on possible exceptions to, or exemptions from, local privacy laws. Non-U.S. commentators have also suggested that treaty partners with exchange of information agreements already have sufficient protections in place for the IRS to request information as required, and, thus, it is not necessary or appropriate to impose additional information gathering and reporting requirements on non-U.S. entities.

Other recommendations made by the insurance industry include an exclusion for insurance contracts with a cash value of less than $50,000.[11] Several commentators noted that retirement plans and pension plans are frequently regulated; investment in a retirement pension plan to effect tax evasion is generally not a very wise choice since the possibility of any tax evasion is minimal and, therefore, any contract issued with respect to a government-regulated pension plan or government-sanctioned private retirement account should be excluded from the definition of financial account. Recommendations to exclude any group annuity contracts or group cash value insurance contracts were made for the same reason; i.e., nominal if any opportunity for tax evasion. Similar rationale was expressed in comments to exclude any cash value contract where the cash value cannot be accessed or can be accessed but only with substantial charges, penalties, fees or taxation in the jurisdiction where the contract was issued—there is simply no opportunity for tax evasion.

Reinsurance

Comments submitted by the reinsurance industry and associations generally agreed with the language in Notice 2010-60 that the issuance of reinsurance contracts without cash value does not implicate the concerns of chapter 4 and unanimously encouraged Treasury and the IRS to exclude reinsurance companies from the definition of financial institution. Commentators pointed out that reinsurance transactions are entered into for the purpose of freeing up capital in order to increase underwriting capacity, and spread risk at a global level. Reinsurance transactions are between insurance companies; they are exclusively business-to-business transactions and do not affect individual policyholders, much less present the tax evasion potential that underlies the provisions of chapter 4. Comments, again unanimously, recommend that Treasury and the IRS exclude both property and casualty as well as life reinsurers from the definition of financial institution because reinsurance transactions do not affect individual policyholders; and, hence, no tax evasion as contemplated by chapter 4 is effected by reinsurance. Nor does reinsurance of life or annuity business create a cash value, and reinsurance recoveries are not available to individuals.[12] Payments made under reinsurance contracts are made to the ceding company and are based on the loss experience of the ceding company on the underlying contracts. Because some reinsurers are authorized to reinsure both life and property and casualty business, exempting only property and casualty reinsurers may leave some reinsurance companies in limbo with respect to whether or not they had to meet the reporting and documentation requirements of chapter 4. Comments go on to suggest that exempting all reinsurance companies is consistent with the policy goals of chapter 4. There are some companies that enter into both direct insurance and reinsurance, but these are more typically property and casualty companies that generally do not issue cash value life insurance policies. Thus, comments have requested a more precise definition of a financial institution to exclude reinsurance companies and a more complete definition of a cash value policy that will be treated as a U.S. account.

Holding Companies

Several insurance commentators addressed Notice 2010-60's reference to holding companies. The notice states that Treasury and the IRS intend to issue regulations that will create an exemption from FFI status to a holding company whose subsidiaries are not treated as FFIs under chapter 4. If the subsidiaries include FFIs, however, the holding company will presumably be treated as an FFI subject to chapter 4's information reporting and withholding requirements. The consensus of the comments was that because holding companies do not have "financial accounts" or "U.S. account holders," the compliance and administrative burden of the IRS receiving a large number of reports showing no accounts would be excessive relative to any tax evasion prevention, therefore the commentators recommend that holding companies be excluded from the definition of financial institution.

BUT QUESTIONS REMAIN

Treasury and the IRS stated in Notice 2010-60 that proposed regulations will be issued with sufficient time for affected parties to implement the systems and processes necessary to fully comply with the withholding, information gathering and reporting requirements imposed by chapter 4. However, comments and recommendations from the insurance industry have gone unaddressed with the second round of guidance provided in Notice 2011-34, and the effective date of Jan. 1, 2013 is rapidly approaching.

Generally, it is in the best interest of the insurance industry that Treasury and the IRS reach the answers and solutions most appropriate for its special circumstances. Hence, potentially affected parties are hopeful that the questions raised and recommendations made by the insurance industry are still percolating through Treasury and the IRS, but with the effective date rapidly approaching, it is difficult to sit quietly with so many issues unanswered. For their part, Treasury and the IRS continue to seek further comment from the insurance industry. On May 6, at the Insurance Companies session at the ABA Tax section meeting, Treasury representatives urged the industry to submit additional comments on how to define an "active trade or business,"[13] and how to define cash value and cash surrender value, the latter being on the IRS priority guidance list this year, and how those definitions might apply to FATCA requirements.

While Treasury and the IRS keep asking taxpayers to provide comments, numerous questions remain for Treasury and IRS determination, such as the following:

The Questions Are Fundamental

The requested guidance goes to issues as basic as seeking clarification around, "When will an insurance company be an FFI and when will it be exempted?" and "Which insurance products will be deemed to be U.S. accounts?"

Speculation around what the final rules might look like has resulted from inquiries as to, "How much cash value will be deemed to be too much cash value?" and, "Will the IRS exempt certain contracts that preclude loans or withdrawals prior to death?"

From a policy perspective, many have asked, "Is there really any potential for tax evasion in a retirement or pension fund?"

The Questions Are Practical

What will be the implications of chapter 4 for insurance companies resident in treaty jurisdictions? Will chapter 4 "trump" the treaty provisions for pensions and annuities?

What policies will be subject to FATCA? How will the term "cash value" be defined? For example, will a policy that provides for return of premium have cash value for purposes of FATCA? Will some form of low cash value exception be provided, such as the $50,000 exception noted above? What about the suggested exemption from FATCA for policies with level premiums under $10,000, or values under $500,000? What is meant by the term, "private placement"?

The Questions Ask How Far Insurance Companies Will Need to Go to Comply

What are the implications for existing contracts? Insurance contracts are not deposit accounts or custodial accounts; they are contracts entered into by unrelated parties (excluding some which are related party reinsurance transactions). How will Treasury and the IRS address the concerns of non-U.S. life insurers with regard to the potential need to research old files on preexisting life insurance contracts? Will Treasury and the IRS expand the exceptions for older contracts and low cash value contracts?

The Questions Ask How to Put a Square Peg in a Round Hole

How will Treasury and the IRS address the issue of withholding on recalcitrant policyholders when the contract does not provide for any withholding by the insurer, or if such withholding is prohibited by local regulation? What happens when FATCA requires an account to be closed, but local regulations do not permit an insurance company to cancel a contract? How will Treasury and the IRS define pass-thru payments in the insurance context, where all assets belong to the insurance company and there is a separate liability to the insured?

How will Treasury and the IRS address the issue of withholding on recalcitrant policyholders when the contract does not provide for any withholding by the insurer, or if such withholding is prohibited by local regulation?

THE INDUSTRY NEEDS ANSWERS

The statute contains highly specific requirements, but it also leaves much to the discretion of the Secretary. Without final guidance, and with the effective date looming, foreign

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financial institutions are unsure as to whether they are subject to FATCA's compliance rules, and, if so, how to come into compliance; whether they will be in a class exempted by Treasury; whether to make an election; whether they should begin to establish processes by which they can acquire the required information not already in their databases; whether to identify U.S. account holders and request waivers; and what to do if they are in treaty partner countries.

Given the relatively short amount of time to get into compliance, it has become incumbent upon companies to begin the process of undertaking comprehensive, resource-intensive assessments of their businesses, and prepare to institute potentially significant change processes across their organizations. In many cases, they may be granted an exemption, or otherwise find compliance to be less burdensome than anticipated; but absent guidance, it is necessary to do so given the potential consequences of being in noncompliance.

END NOTES

* The authors thank Ted Clabault and Yvonne Fujimoto for their assistance in producing this article.

1 P.L. 111-147.

2 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended. Chapter 4 includes sections 1471–1474.

3 Section 501(a) is a revised version of provisions in a bill titled the "Foreign Account Tax Compliance Act of 2009," H.R. 3933, S. 1934 (introduced on Oct. 27, 2009), and is sometimes referred to as FATCA.

4 FFIs can enter into Agreements with the IRS that establish the reporting requirements. As discussed in further detail below, Notice 2010-34 sets out guidelines and Treasury has indicated it intends to publish a form FFI Agreement prior to the effective date of the new chapter 4 provisions.

5 The term "withholdable payment" is defined in section 1473(1)(A) to include: (i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, or periodical gains, profits and income, if such income is from sources within the United States, and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

6 Sections 871(h), (i) and 881(c) and (d).

7 Section 1471(b)(3) permits certain FFIs to make elections to be withheld upon. This has become an issue as the U.S. entity does not have the ability to say "no."

8 2010-37 I.R.B. 329.

9 Section 1471(d)(5) defines "financial institution" (hereinafter, "FI") by reference to three alternative activities: (A) deposit-taking in a banking or similar business; (B) the holding of financial assets for the account of others; and (C) engaging primarily in the business of investing, reinvesting or trading in financial assets including securities, partnership interests and commodities, and derivative interests therein.

10 Comments of Allianz SE, dated Nov. 11, 2010, Doc 2010-24092.

11 This provision is consistent with the definition of a U.S. account in section 1471(d)(1)(A), which excepts accounts held by a natural person with an aggregate value of less than $50,000.

12 Except in the rare case of assumption reinsurance wherein the reinsurer steps into the shoes of the ceding company and enters into a direct insurance relationship with the insured. It would be very easy, if necessary, to make an exclusion for assumption reinsurance transactions.

13 This is relevant, for example, with respect to the ability to exclude payments to NFFEs.

INSURANCE COMPANY BAD DEBT

By Samuel A. Mitchell and Peter H. Winslow

The large investment losses that insurance companies suffered during the credit crisis are adding to the workload of their tax departments and the Internal Revenue Service (IRS). Many companies are involved in tax controversies with the IRS, and others are dealing with tax accounting issues arising from the losses. Because of the natural time lag involved in most tax examinations, the partial worthlessness deductions that companies reported in 2008 and 2009 are just now ripening into proposed adjustments from IRS examiners. Many insurance companies reported large partial worthlessness deductions that are now under scrutiny by IRS examiners. The examinations have created uncertainty and are beginning to result in resource demands on the part of the industry as IRS examiners attempt to verify compliance with bad debt deduction requirements. For this reason, the industry and the IRS have agreed to try to resolve the problem through the IRS's Industry Issue Resolution ("IIR") program.[1] We have addressed insurance company bad debts several times in prior *Taxing Times* articles,[2] but did not have the benefit of the IRS examiners' positions at the time those articles were written. This article summarizes some of the key issues the IRS and insurance companies are grappling with in the tax compliance and examination process that led to the IIR project.

INCOME ACCRUALS

There are two major tax issues to think about when investments are impaired. The first is whether to continue to accrue interest or discount on the instruments. The second is whether a principal write-down is available, and if so, when. Related to the second issue is whether any write-down will be ordinary or capital in character. The income accrual issue has not drawn significant attention thus far from IRS examiners, but is worth reviewing because of its important tax compliance implications. Treasury Regulation § 1.451-1(a) applies the accrual method of accounting and requires an income inclusion when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. For interest, this standard is met when interest is economically earned, payment is due or payment is received. A common law exception to this requirement to accrue income applies when there is a "reasonable doubt as to collectability" at the time the standard otherwise would be satisfied.[3] In the banking context, the IRS has taken the position in a revenue ruling that the doubt as to collectability must be "substantial" in order for the accrual exception to apply.[4]

There are additional issues regarding how the income accrual exception applies in the context of Original Issue Discount ("OID") and market discount, which are economic substitutes for stated interest.[5] OID is the discount at original issue and is equal to the excess of the stated redemption price at maturity over the issue price.[6] Taxpayers other than life insurance companies are required to follow detailed income recognition rules in I.R.C. § 1272 under which they recognize OID in income on a constant yield basis over the term of the instrument.[7] The income recognition rules are intended to replicate accrual accounting for OID. The IRS has taken the position in a widely criticized Technical Advice Memorandum ("TAM") that the common law exception to income accrual for doubt as to collectability does not apply at all to OID and that taxpayers must continue to accrue OID even after they know with certainty that they will never collect the discount.[8] The IRS based its conclusion primarily on the fact that the OID rules in I.R.C. § 1272 do not provide an explicit exception for doubtful collectability. This ignores the fact that the exception to income accrual is a common law exception based on the basic principle that a taxpayer "cannot be charged to have realized an income unless there exists reason for believing that the income is likely to be paid."[9] The IRS made other technical arguments in support of the conclusion, but there is a general consensus in the tax bar that the TAM is erroneous and that the same common law exception that applies to interest accruals also applies to OID.[10]

The market discount rules present other issues. These issues have not been addressed by the IRS in the context of statutory impairments, at least to our knowledge, but the answers appear to be reasonably clear. Market discount is equal to the excess of the stated redemption price at maturity over the holder's basis in the instrument acquired at purchase in the secondary market.[11] Taxpayers may elect not to recognize

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market discount currently as it accrues but instead recognize it as ordinary income on sale or maturity.[12] However, taxpayers that have elected to defer current recognition that receive payments must recognize such payments as ordinary income to the extent of previously accrued market discount that has not been recognized.[13] Because market discount, like OID, is simply a substitute for stated interest, the common-law exception to interest income accruals should also apply to market discount and a taxpayer should not be required to continue accruing market discount if there is no reasonable expectation that the taxpayer will ever collect the discount. There may be an issue, however, with respect to pay-downs. Take, for example, a principal pay-down on a structured debt instrument that is severely distressed. Is a taxpayer required to recognize the previously accrued market discount when the partial pay-down occurs even though the payment is a return of principal and the taxpayer has no reasonable expectation of collecting the previously accrued market discount? The answer to this question may be yes because the recognition rule in I.R.C. § 1276(a)(3) requires payments to be treated as market discount to the extent it has been accrued.

For life insurance companies, all of these income accrual matters should be considered in light of I.R.C. § 811(b). That provision permits life insurance companies to accrue OID and market discount under their statutory accounting method if the method clearly reflects income. Therefore, if the company stops recognizing either OID or market discount under its statutory accounting method it should not be required to do so for tax purposes if it is using statutory accounting for its taxable income recognition.[14]

PRINCIPAL WRITE-DOWNS

The second set of tax issues to think about when an instrument is impaired concerns the rules that apply to the timing and character of the write-downs. A corporate taxpayer that holds a business debt that is not a "security" under I.R.C. § 165(g) has the discretion to take ordinary partial worthlessness deductions as the debt becomes worthless in part or to wait until the debt is sold or becomes wholly worthless to take the loss.[15] The application of the rules can be significant both in terms of the timing of the loss and its character. The time value of reporting an ordinary deduction for a partial worthlessness deduction versus waiting for an exchange or a determination of complete worthlessness can be significant depending on the amount of the impairment and the term of the instrument. The character also can be important because a loss on exchange or sale would be capital in nature and the IRS may argue that a loss on termination may also be capital.[16] Capital losses can be offset only against capital gains and are subject to a five-year limitation on carryover to subsequent years.

This is the area in which most of the recent IRS activity has occurred and the scrutiny is intensifying as the 2008 and 2009 tax years come under audit. Many insurance companies have claimed partial worthlessness deductions consistent with their statutory impairments on structured debt instruments of various types and on commercial mortgages that are not securities. Most of the controversy so far has centered on the application of the partial worthlessness rules to impairments of regular interests in Real Estate Mortgage Investment Conduits (REMIC regular interests). Under a REMIC structure, a pool of mortgages is securitized and divided into various tranches for sale to investors. The REMIC trust issues regular interests that represent the obligations of the REMIC trust and are treated as debt instruments to the investor for all tax purposes.[17] REMIC regular interests are sold in registered form and generally have the characteristics of a security; however, they do not meet the definition of a security under I.R.C. § 165(g) because they are issued by a trust. The definition of a security in I.R.C. § 165(g) covers only instruments that are issued by a corporation, government, or subdivision thereof. This is an important distinction because it opens the door for partial worthlessness deductions under I.R.C. § 166.

The IRS examiners for the most part appear to agree that REMIC regular interests are non-securities and that they qualify for some level of partial worthlessness deductions under I.R.C. § 166 and the regulations thereunder.[18] However, the qualification for the deduction is only the threshold question. The next issue is whether the actual amount claimed is worthless under the tax standard. The IRS and insurance company taxpayers have not had much success in resolving the amounts of the deductions largely because they are pursuing different avenues for substantiation of the deductions. The IRS for the most part is examining the details of substantiation under the general standard for worthlessness, whereas insurance company taxpayers for the most part are relying on the conclusive presumption in Treas. Reg. § 1.166-2(d) for regulated industries that the worthlessness standard has been met.

Some background discussion of the two approaches will help explain this problem. The IRS has the discretion to allow a partial worthlessness deduction (1) to the extent the taxpayer charges the amount off on its financial books and records in the same year it seeks the partial write-down,[19] and (2) to the extent the taxpayer can prove that the portion it wrote down on its books actually was worthless under the tax standard.[20] Under the general tax standard for determining worthlessness, a debt is worthless to the extent collection appears to the reasonable business person exercising sound business judgment to be hopeless.[21] Although the Commissioner is limited in his or her authority to challenge the reasonable exercise of sound business judgment,[22] the examination of whether the standard has been met requires a detailed evaluation of the underlying facts. The conclusive presumption in Treas. Reg. § 1.166-2(d), on the other hand, does not require a detailed examination of the facts underlying the deduction. Under that provision, a regulated company's book charge-off is presumed to be correct in the year of the charge-off if it is made under established policies and procedures of the regulator and if the regulator confirms this fact upon its first examination of the company's books and records for the year of the charge-off.

IRS EXAMINATION APPROACH

In examining REMIC regular interests under the general standard in the regulations, the IRS has attempted to dig deep into the background of each regular interest and the taxpayers' investment and accounting determinations of worthlessness under statutory accounting standards. The investment and accounting evaluations are complex and difficult to present to IRS examiners in auditable form. Moreover, many insurance company taxpayers have been reluctant to devote the resources to provide detailed explanations because the conclusive presumption obviates the need to do so. IRS examiners generally have taken the position that charge-offs based on estimates of future cash flows do not satisfy the tax standard of worthlessness because they consider anticipated future defaults that have not yet occurred and because non-credit-related factors, such as prepayment assumptions, are considered. Insurance companies disagree with the IRS audit position and have been unwilling to recalculate future cash flow projections based on the IRS's more restrictive view of worthlessness in the REMIC context. As a result, the IRS examiners appear to have focused their efforts on remittance advices received from REMIC trustees to propose deduction disallowances. The monthly remittance advices typically present delinquency and default information for the various tranches and show allocations of the loss of principal for each tranche. REMICs, like other structured securities, typically have a capital structure in which higher-ranked tranches are protected by credit support in the form of subordination of lower-ranking tranches. The lower-ranking tranches typically absorb losses on the underlying mortgages first. Another typical form of credit support is excess collateral.[23] The remittance advices show allocations of principal losses to particular tranches when enough mortgages have defaulted and the collateral has been liquidated to exhaust the credit support underlying the tranche. The losses typically are not allocated and reported in the remittance advice until the collateral has been liquidated. Therefore, the remittance advice approach that many IRS examiners have taken is, in essence, a liquidation approach to valuation of the partial worthlessness. This approach in most cases has resulted in only a few current-year deductions in the years under examination so far, even though it is abundantly clear that the companies have had large losses charged against book earnings under statutory accounting standards.

Application of the statutory accounting standards has resulted in impairments that are made in advance of the loss allocations flowing through the remittance advices the IRS has examined.

INSURANCE COMPANY RELIANCE ON THE CONCLUSIVE PRESUMPTION

In contrast to the liquidation approach of IRS examiners, taxpayers' conclusive presumption approach conforms the tax partial worthlessness deductions to the statutory accounting impairments the companies are required to record under Statements of Statutory Accounting Principles. Application of the statutory accounting standards has resulted in impairments that are made in advance of the loss allocations flowing through the remittance advices the IRS has examined. For REMIC regular interests and other structured securities, the statutory accounting rules require an analysis of whether a decline in fair value is attributable to an other-than-temporary impairment. This is done in part through the projection of cash flows. In projecting the cash flows, the companies are required to consider a variety of credit-related factors such as the payment terms, the financial condition of the issuer, expected defaults, the value of the collateral, industry analyst reports, sector credit ratings and other market data pertaining to collectability and the ability of subordinated interests to absorb losses.[24] If the company does not intend to sell the instrument and has the ability to hold it to recovery, it is required to write the instrument down to the present value of the projected cash flows discounted at the pricing yield.[25] This type of write-down is intended to capture the credit-related portion of a decline in fair value.[26] If the company has the intent to sell the instrument or if it does not have the ability to hold it to recovery, the company is required to write the instrument

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down to fair value and charge the write-down against current earnings.[27]

APPLICATION OF THE CONCLUSIVE PRESUMPTION TO INSURANCE COMPANIES

The threshold issue the IRS has had to consider in examining taxpayers' partial impairment write-downs based on the statutory accounting standards is whether the conclusive presumption in Treas. Reg. § 1.166-2(d) applies to the insurance industry. The regulation subsection, which is titled "Banks and other regulated corporations," applies to "a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards."[28] IRS examiners generally have accepted that insurance companies are an "other regulated corporation" within the meaning of the regulation because of the strict regulatory environment in which they operate. However, IRS examiners have questioned whether the State insurance regulatory standards are "substantially equivalent" to Federal bank standards as the regulation requires. Some examiners have taken the position that in order for the presumption to apply, the actual statutory accounting standards for the insurance company write-downs must be substantially the same as the standards for bank write-downs of bad loans. This interpretation of the regulation is inconsistent with the historical background of the presumption. The conclusive presumption entered the regulations in 1922,[29] at a time when there were no specific controlling standards for bank write-downs. Thus, it is reasonable to conclude that the reference to "substantially similar" standards refers to the standards of "supervision" of the industry in general, and not to specific standards for write-downs.

There is one court decision regarding whether the conclusive presumption applies to insurance companies as "other regulated corporations" and whether the standards of regulation are "substantially similar." The Court of Claims in *Credit Life Insurance Company v. United States* held that the insurance supervisory authority in the state of Ohio was substantially similar to the authority of Federal banking regulators and that the conclusive presumption applied to a life insurer domiciled in that State.[30] The court considered the general supervisory authority of the state regulators as compared to the underlying policy of the banking regulators under the Office of the Comptroller of the Currency ("OCC"). In comparing the two regulatory regimes, the court considered Rev. Rul. 79-214, 1979-2 C.B. 90, which identifies the critical criteria for coverage under the regulations as whether the regulator has an established authority to compel the charge-off on the financial statements of the company. The court also considered the underlying policy rationale for the conclusive presumption, which is to ensure that taxpayers subject to banking and similar supervisory regulation receive fair and consistent treatment as between the taxing authorities and their supervisory regulators.[31] These considerations led the court to a holding that the insurance company taxpayer was in a substantially similar position to a bank, that the underlying policy rationale for the presumption applied equally to the insurance company and that the conclusive presumption applied.

ADDITIONAL ISSUES ARISING UNDER THE CONCLUSIVE PRESUMPTION

In addition to questions over the threshold issues of whether insurance regulations are "substantially similar" to banks, IRS examiners have raised several other questions and issues concerning the write-downs under the statutory standards, particularly with respect to REMIC regular interests. First, several IRS examiners have been reluctant to accept the statutory write-downs on REMIC regular interests even if the conclusive presumption were to apply, based on a conclusion that the cash flow projections under the OTTI standard result in deductions for "future anticipated worthlessness." This concern stems from a mistaken view of the instruments. The examiners appear to be looking through the REMIC trust to the underlying mortgagors as the debtors for tax purposes. In their view, it is inappropriate to take a worthlessness deduction for future defaults (*i.e.,* "future anticipated worthlessness") on underlying mortgages. In reality, however, the REMIC trust is the debtor and the cash flows from underlying mortgages are the collateral supporting the trust's obligation. The regulations under the general worthlessness regulations provide that it is appropriate to consider the condition of the debtor and the value of the collateral in determining worthlessness.[32] Considering future defaults on underlying mortgages in this context simply involves an analysis of the condition of the debtor and its ability to pay based on the collateral supporting the debt. Additionally, even if it were appropriate to look through the REMIC trust and consider the mortgagors as the debtors for worthlessness purposes, the regulations provide that it is not necessary to wait until there is a default before taking a worthlessness deduction.[33]

Examiners have also raised issues under Rev. Rul. 84-95, 1984-2 C.B. 53. In that ruling, the IRS held that the conclusive presumption did not apply to a write-down under rules promulgated by the OCC that required a bank to account for Other Real Estate Owned at the lesser of net book value or fair value. The process described in the ruling was "based solely on a mechanical comparison of net book value of real estate with its current appraised value."[34] In the ruling the IRS compared the "mechanical" process to other OCC rules covering bad debts, which required the bank to evaluate the write-down in the context of credit-related factors such as "the delinquency or default of a debtor."[35] It concluded that the conclusive presumption did not apply to the fair value write-down because the process did not involve consideration of traditional bad-debt credit-related factors.[36] Rev. Rul. 84-95 should not be an obstacle to the application of the conclusive presumption in the case of REMIC regular interests. The revenue ruling merely holds that the conclusive presumption does not apply unless the regulator treats the write-down as a bad debt (as opposed to a reduction in value of real estate as in the ruling). Moreover, as described above, the current statutory standards result in a write-down that is based on a number of credit-related factors such as the financial condition of the issuer, expected defaults, the value of collateral, industry analyst reports, sector ratings and other factors that bear on the likelihood of collectability.[37] In limited situations involving cases in which the insurance company either intends to sell the instrument or does not have the ability to hold it until recovery, the current statutory accounting standard requires that the instrument be written down to fair value.[38] However, the process for writing down to fair value in these limited circumstances takes place in the context of an OTTI determination. It is not the same type of mechanical mark-to-market approach that applied to the real estate at issue in Rev. Rul. 84-95. In any event, life insurance companies are required to bifurcate the write-down between credit component and non-credit components.[39]

Going beyond Rev. Rul. 84-95, some examiners have questioned whether the conclusive presumption applies only when the regulator's standards are the same standards as would be applied under the general worthlessness standard discussed above. The IRS National Office, however, has conceded in a technical advice that banking standards are binding in the context of the conclusive presumption and that it is not necessary for those standards strictly to adhere to the general standard of worthlessness that would otherwise apply in the context of I.R.C. § 166 and its regulations.[40] This is consistent with case law holding that write-down orders pursuant to regulator orders that are not consistent with general I.R.C. § 166 standards are nevertheless conclusive. For example, in *Citizens National Bank of Orange v. Commissioner,* the court held that a bank order requiring a bank to write down a bond based on a market fluctuation was conclusive.[41] This holding is inconsistent with Rev. Rul. 84-95 and casts doubt on the validity of that ruling. Putting that aside, however, the case at least makes it clear that the bank standards under the conclusive presumption do not have to be the same as the general worthlessness standard.

These issues are complex and ripe for resolution on a global basis under the IIR process. If all goes well, by the time this article is published, the IRS and the insurance industry should be well down the path of resolving these issues so that they do not result in an expensive prolonged dispute.

END NOTES

1 The Industry Issue Resolution (IIR) process is described in Revenue Procedure 2003-36, 2003-1 C.B. 859. In late March 2011, the IRS accepted the issue into the IIR program pursuant to an industry request that was supported by the American Council of Life Insurers.
2 *See Tax Aspects of Nonperforming Assets, 4 Taxing Times 28 (Sept. 2008); REMIC Impairments May Qualify as Worthless Bad Debts, 5 Taxing Times* 50 (May 2009); *SSAP 43R and Tax Standards for Partial Worthlessness Deductions*, 6 *Taxing Times* 27 (May 2010).
3 *Jones Lumber, Inc. v. Commissioner*, 404 F.2d 764, 766 (6th Cir. 1968). *See also Corn Exchange Bank v. United States,* 37 F.2d 34 (2d Cir. 1930); Rev. Rul. 80-361, 1980-2 C.B. 164.
4 Rev. Rul. 2007-32, 2007-1 C.B. 1278.
5 *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965).
6 I.R.C. § 1273(a).
7 *See infra.* discussion regarding life insurance rules under § 811(b).
8 TAM 9538007 (June 13, 1995).
9 *Corn Exchange Bank*, *supra*, 37 F.2d at 34.
10 The IRS's points and the rebuttal arguments are discussed at length in comments submitted to Congress and the IRS on July 23, 2008, by the New York City Bar Committee on Taxation of Business Entities. *See http://www.nycbar.org/pdf/report/ABCNY%20CityBar_%20Distressed_debt.pdf.*
11 I.R.C. § 1278(a)(2).
12 I.R.C. § 1278(b).
13 I.R.C. § 1276(a).

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END NOTES CONT.

14 Many life insurance companies do not follow statutory accounting for market discount accruals because the statutory rules generally require amortization of market discount whereas the tax rules allow it to be deferred to the extent payments have not been received. Statement of Statutory Accounting No. 34 requires discount to be included in earnings as investment income accrued. *See* NAIC, Accounting Practices & Procedures Manual, *Statement of Statutory Accounting Principles No. 34,* Investment Income Due and Accrued, para. 3 (Volume I, as of March 2011).

15 A "security" for this purpose is defined as a stock, subscription right or bond, debenture, note or certificate or evidence of indebtedness with interest coupons or in registered form issued by a corporation, government or political subdivision thereof. *See* I.R.C. § 165(g).

16 I.R.C. § 1271(a)(1) provides that amounts received by the holder on the retirement of a debt instrument are deemed to be received in an exchange. If this provision applies, the exchange gives rise to a capital gain or loss, not an ordinary loss.

17 *See* I.R.C. § 860B(a), which provides that "[i]n determining the tax under this chapter of any holder of a regular interest in a REMIC, such interest (if not otherwise a debt instrument) shall be treated as a debt instrument." REMICs also issue residual interests, which essentially represent the equity in the REMIC and are not taxed as debt instruments. *See generally* I.R.C. § 860C.

18 In a few cases, IRS examiners have asserted that regular interests that were issued with OID are not eligible for partial bad debt deductions under I.R.C. § 166 based on a theory that the deductions would be "negative OID," which is prohibited under the legislative history of the OID provisions. *See Glick v. United States,* 96 F. Supp. 2d 850, 871 (S.D. Ind. 2000) (citing H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986)). This issue is beyond the scope of this article. However, in our view the *Glick* case is limited to a narrow set of facts. It dealt with REMIC regular interests that gave the holder a right to a very small amount of principal associated with interest at a high coupon rate (sometimes exceeding 1,000 percent). The instruments essentially were Interest Only and therefore were especially vulnerable to prepayment risk. The taxpayers in the *Glick* case suffered losses because prepayments accelerated as a result of decreasing interest rates (*i.e.,* the underlying mortgages were refinanced). The legislative history reflected the intent to prevent temporary losses that could result from the application of the OID income inclusion formula as a result of prepayments, and not to prevent taxpayers from taking permanent losses from credit-related events.

19 *See* Treas. Reg. § 1.166-3(a)(2)(ii).

20 *See* Treas. Reg. § 1.166-2.

21 *See PepsiAmericas, Inc. v. United States*, 52 Fed. Cl. 41, 47 (2002).

22 *See Portland Mfg. Co. v. Comm'r*, 56 T.C. 58 (1971); *Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984).

23 Excess collateral would mean, for example, that a tranche with $100 million in principal may be supported by $110 million in mortgages. Additional forms of credit support are excess interest-rate spreads and financial guaranty insurance from a monoline financial guaranty insurer. Excess interest rate refers to the spread between the underlying mortgages and the lower certificate rate on the regular interest.

24 *See* NAIC, *supra* SSAP 43R para. 40, listing these and other factors. This statement was effective beginning Sept. 30, 2009. The standard it replaces was SSAP 43, which was similar to SSAP 43R but did not require the cash flows to be discounted. An additional standard that never became required and eventually was withdrawn was SSAP 98. SSAP 98 essentially was a fair value standard.

25 *See id.* para. 33.

26 *See id.* para. 33, Fn 8.

27 *See id.* para. 30-31.

28 Treas. Reg. § 1.166-2(d)(1).

29 *See* T.D. 3262, C.B. I 1 (1922).

30 *Credit Life Ins. Co. v. United States,* No. 585-84T (Cl. Ct. 1990), *rev'd on other grounds,* 948 F.2d 723 (Fed. Cir. 1991). Unfortunately, the Claims Court gave this holding in a bench ruling which was not published. The case was reversed on appeal on other grounds.

31 This policy rationale is explained in Rev. Rul. 80-180, 1980-2 C.B. 66 and in several cases, including United States v. Beckman, 104 F.2d 260 (3d Cir. 1939) and *Citizens Nat'l Bank of Orange v. Comm'r,* 74 F.2d 604 (4th Cir. 1935). *The Citizens Nat'l Bank* court explained the rationale as follows:

> Here we have a case in which one branch of the government can compel the taxpayer to take an action with regard to its securities which, when taken, will not be recognized by another branch of the government. This is not fair to the taxpayer. There should be at least some semblance of coordination between the several branches of government in dealing with a taxpayer.

74 F.2d at 605.

32 *See* Treas. Reg. § 1.166-2(a), which provides as follows: "In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor."

33 *See* Treas. Reg. § 1.166-1(c), which provides as follows: "The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under I.R.C. § 166."

34 Rev. Rul. 84-95.

35 *Id.*

36 The General Counsel Memorandum underlying the Revenue Ruling makes it clear that the primary reason the IRS held that the conclusive presumption did not apply was that the "mechanical" fair value write-down of the real estate did not involve any type of consideration of "bad debt criteria." GCM 39023 (Aug. 23, 1983).

37 NAIC, supra SSAP 43R, para. 40. Write-downs under the earlier applicable SSAP 43 were evaluated under credit standards as well. Additionally, fair value write-downs under SSAP 98 for companies that adopted it were evaluated in a similar context of OTTI determinations in which credit-factors were considered. The write-downs were not the simple, mechanical fair value write-downs described in Rev. Rul. 84-95.

38 NAIC *supra* SSAP 43R, para. 30-31.

39 SSAP 43R paragraph 36 requires life insurers to account for the credit component in the Asset Valuation Reserve and the non-credit component through the Interest Maintenance Reserve.

40 Technical Advice Memorandum 9122001 (Feb. 8, 1991).

41 *Citizens Nat'l Bank, supra*, 74 F.2d at 606-607. The IRS specifically noted and commented on this aspect of the case in General Counsel Memorandum 37875 (March 6, 1979).

IRS RULES LIFECYCLE FUNDS COMPLY WITH INVESTOR CONTROL DOCTRINE

By Bryan W. Keene

In PLR 201105012 (Oct. 14, 2010), the IRS addressed the application of the investor control doctrine to certain "Lifecycle Insurance Funds." The Lifecycle Insurance Funds are insurance-dedicated mutual funds, meaning they generally are available only in support of variable contracts.[1] Each fund follows a "target date" investment strategy, where the underlying investments gradually become more conservative as a targeted retirement date approaches. Prior to the transaction that the taxpayer life insurer proposed, each Lifecycle Insurance Fund invested exclusively in shares of other insurance-dedicated mutual funds. The taxpayer proposed allowing the Lifecycle Insurance Funds to invest some or all of their assets in certain mutual funds and investment partnerships that are not insurance-dedicated, but rather are available directly or indirectly for investment by members of the general public. The IRS concluded that the proposed investments would not violate the investor control doctrine. As a result, for federal income tax purposes, the insurer (rather than the variable contract holders) is treated as owning the separate account assets underlying the contracts.

BACKGROUND ON THE INVESTOR CONTROL DOCTRINE

For federal income tax purposes, a life insurance company normally is treated as the owner of the separate account assets it holds in support of variable annuity and life insurance contracts it issues. The IRS established a limited exception to this treatment, however, in a series of revenue rulings colloquially known as the "investor control" rulings.[2] Under those rulings, the policyholder, rather than the insurance company, is treated as the owner of the separate account assets if he or she has sufficient incidents of ownership in them. The result is that the tax benefits of the insurance contract are lost, and the policyholder is currently taxable on income generated by the separate account assets.

The investor control rulings were predicated on the view that an investor should not be able to choose between purchasing a security directly, thereby subjecting the earnings to current taxation, or "wrapping" the investment in a variable contract, thereby deferring current taxation on those earnings. To this end, the rulings reflect the view that the party who directs the selection, management and disposition of the separate account assets typically will be considered the owner of those assets for federal income tax purposes.[3] In applying this principle, the investor control rulings often focus on the "public availability" of the investments supporting the contract. If the same investment is available without regard to the contract, *i.e.*, if it is publicly available, and the policyholder can either directly or indirectly instruct the insurance company to purchase that investment, then the policyholder has sufficient incidents of ownership in the investment to be viewed as its owner for tax purposes.[4]

Of course, almost every individual asset held in support of a variable contract (stocks, bonds, *etc*.) is "publicly available" at some level. As a result, the doctrine cannot reasonably be viewed as focusing only on whether any *particular* investment is publicly available—if this was the standard, virtually no variable contract would pass muster under the doctrine. Rather, the investor control analysis must focus on whether, in the aggregate, the assets supporting the contract represent a pool of investments that is available only through the purchase of a variable insurance product.

THE PROPOSED INVESTMENT STRUCTURE IN PLR 201105012

The Lifecycle Insurance Funds in PLR 201105012 are funds-of-funds in which a top-tier, insurance-dedicated mutual fund invests in certain lower-tier funds. Prior to the proposed transaction, the lower-tier funds were other insurance-dedicated mutual funds. The taxpayer proposed modifying the composition of the lower-tier funds to include certain mutual funds and investment partnerships that are not insurance-dedicated. In particular, the taxpayer proposed allowing the Lifecycle Insurance Funds to invest some or all of their assets in "Public Funds" and "Central Funds."

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The Public Funds are mutual funds that offer shares for purchase directly by members of the general public, without having to purchase a variable contract. The Central Funds also are "publicly available" in this sense, albeit indirectly rather than directly. In that regard, the Central Funds are available to certain entities and accounts that the taxpayer's affiliates manage (such as the Public Funds), and members of the general public can invest directly in those entities and accounts. Thus, public access to the Central Funds is available indirectly without purchasing a variable contract. Some of the Central Funds are available to a wide array of other entities and accounts, and other Central Funds were created specifically for investment by Public Funds that follow a lifecycle or target date investment strategy. The ruling calls this latter category of Central Funds the "Lifecycle Central Funds."

The taxpayer indicated to the IRS that the proposed investments in Public Funds will give the investment manager greater discretion and flexibility in managing the Lifecycle Insurance Funds, with the accompanying potential of achieving better performance results and greater investment risk diversification for variable contract holders. Similarly, the taxpayer indicated that the proposed investments in Central Funds will broaden the investment options of the Lifecycle Insurance Funds and allow them to take advantage of certain operational efficiencies and the expertise of other investment managers. With respect to the Lifecycle Central Funds (*i.e.*, the subset of Central Funds described above), the taxpayer indicated that it expects the proposed investments in such funds to occur gradually over several years, but ultimately they could represent a significant portion of a top-tier Lifecycle Insurance Fund's investments, potentially exceeding its investments in other types of lower-tier funds.

The Public Funds are mutual funds that offer shares for purchase directly by members of the general public, without having to purchase a variable contract.

Each Lifecycle Insurance Fund's investments in Public Funds and Central Funds will comply with the investment diversification requirements of Internal Revenue Code section 817(h) and the regulations thereunder. However, the percentage of a Lifecycle Insurance Fund's investments in any Public Fund or Central Fund will not be fixed in advance of a contract holder's investment and may be changed by the investment manager at any time. In that regard, the investment manager will use its sole and absolute discretion regarding the nature and extent of any investments in Public Funds or Central Funds. Contract holders will have the ability only to allocate premiums and cash values among the sub-accounts of the insurer's separate account that correspond to the Lifecycle Insurance Funds.

CONCLUSION IN PLR 201105012

The IRS concluded in PLR 201105012 that the Lifecycle Insurance Funds' proposed investments in Public Funds and Central Funds will not run afoul of the investor control doctrine. As a result, such investments will not cause the variable contract holders to be treated as owning the assets underlying their contracts for federal income tax purposes.

In reaching this conclusion, the IRS noted that the investor control doctrine applies based on all the relevant facts and circumstances. With regard to the facts presented, the IRS observed that shares of the Lifecycle Insurance Funds themselves are not publicly available. In addition, the IRS noted that all investment decisions regarding the Lifecycle Insurance Funds are made by the investment manager in its sole and absolute discretion, and that a variable contract holder cannot direct a Lifecycle Insurance Fund's investment in any particular asset nor is there any agreement or plan with the contract holder regarding such an investment. Finally, the IRS observed that the investment strategies of the Lifecycle Insurance Funds are "sufficiently broad to prevent a variable contract holder from making particular investment decisions through investment in a Lifecycle Insurance Fund," and that only the insurer can add or remove investment options under the contracts. Based on these facts, the IRS concluded that no investor control violation arises.

CONSISTENCY WITH EARLIER RULINGS

The IRS has reached this same conclusion in the context of other funds-of-funds that proposed including public mutual funds in their lower-tier investments. For example, in PLR 200601006 (Sept. 30, 2005), the IRS reached a similar conclusion with respect to insurance-dedicated lifecycle funds that proposed investing a portion of their assets in public mutual funds, subject to certain self-imposed limits (which were redacted from the public version of the ruling). Likewise, in PLR 200420017 (Feb. 2, 2004) and PLR 9839034 (June

30, 1998), the IRS reached a similar conclusion with respect to insurance-dedicated funds that proposed investing exclusively in shares of public mutual funds. Furthermore, in PLR 200025037 (Mar. 24, 2000) and PLR 9748035 (Aug. 29, 1997), the IRS reached a similar conclusion with respect to insurance-dedicated funds that invested a portion of their assets in public mutual funds and the remaining portion in various debt and/or equity securities. As a result, it seems clear that an insurance-dedicated fund-of-funds arrangement in which the lower-tier investments are comprised partially or wholly of public mutual funds will not necessarily run afoul of investor control principles, as long as such investments otherwise comply with those principles—including the investment manager retaining sole and absolute discretion over which public funds will be used in the arrangement.

END NOTES

[1] More specifically, "insurance dedicated" means that, except as otherwise permitted by Treas. Reg. section 1.817-5(f)(3), all the beneficial interests in the Lifecycle Insurance Funds are held by one or more insurance companies and public access to the Lifecycle Insurance Funds is available exclusively through the purchase of a variable contract.

[2] Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12, *modified by* Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.

[3] The investor control rulings state that this view is based on the judicial notion that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Rev. Rul. 2003-91 (quoting Corliss v. Bowers, 281 U.S. 376 (1930)). This notion, in turn, is a specific application of the long-standing judicial doctrine that the substance of an arrangement, rather than its form, controls its characterization for federal tax purposes. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465 (1935).

[4] One question that sometimes arises under the investor control doctrine is whether offering too many investment options effectively enables the policyholder to choose among specific investments and thereby exercise impermissible control over the separate account assets. While the IRS rulings have not drawn specific lines in this regard, one ruling favorably described a variable contract that offered 20 investment options. *See* Rev. Rul. 2003-91. That figure, however, was not described as an upper limit for all purposes of the investor control doctrine. Rather, the standard expressed in the rulings to date is that a policyholder's choices should be limited to "broad, general investment strategies" in order to remain consistent with investor control principles. *See, e.g.*, Rev. Rul. 82-54.

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ADDITIONAL IRS RULINGS ON CONTINGENT DEFERRED ANNUITIES

By John T. Adney and Bryan W. Keene

In the May 2011 issue of *Taxing Times*, we reported on two private letter rulings (201105004 and 201105005) released to the public last February in which the IRS again addressed the federal income tax treatment of insurance arrangements sometimes referred to as "stand-alone withdrawal benefits" or "contingent deferred annuities" ("CDAs"). Late in April 2011, the IRS released two more private rulings, PLRs 201117012 and 201117013, that it had issued on Jan. 20 of this year covering the same subject matter on largely similar facts. The new rulings went somewhat further, however, addressing two issues not covered in the prior rulings on CDAs.[1]

The CDA contract involved in the new rulings, which was a group annuity contract, provided guaranteed lifetime withdrawal benefits linked to an investment account that the owner of a certificate under the group contract established with a financial institution (called the "Sponsor" in the rulings) unrelated to the insurance company that issued the contract. PLR 201117013, discussed first below, was issued to a prospective certificate owner to address federal income tax issues pertinent to that taxpayer, while PLR 201117012 was issued to the insurer to provide guidance on its own tax treatment and reporting obligations.

The crux of the GLWB promise is that if withdrawals conform to this requirement but the account nonetheless is exhausted during the life of the owner (or the beneficial owner in the case of an entity-owned certificate), the insurer will begin paying the owner an "annual benefit."

FACTS OF THE NEW RULINGS

PLRs 201117012 and 201117013 were companion rulings, and hence their facts are identical. According to the rulings, the insurer will issue the group annuity contract to the Sponsor and will provide an individual certificate under the contract to each of the certificate owners, evidencing the insurer's promise of lifetime withdrawal benefits linked to the investment account that each certificate owner establishes with the Sponsor. That owner may be an individual, in which case he or she will be the measuring life for the benefit provided under the certificate, or may be an entity as allowed by section 72(u),[2] in which case the measuring life will be a natural person possessing a beneficial interest in the related investment account. The rulings note that the group contract may be assigned by the Sponsor with the insurer's consent, whereas the certificates issued under the contract will be non-assignable.

The certificate owner may allocate values in the investment account established with the Sponsor among certain "permitted" investment "profiles." These profiles, according to the rulings, were designed to limit volatility and investment losses within the account (which limits, we note, enable the insurer to make its benefit promise and do so for the fees to be charged). The permitted investments may include mutual funds and exchange-traded funds; some of these funds may be managed by an affiliate of the insurer, although the permitted investments will not be limited to insurer-affiliated funds. The owner will be required to rebalance the account assets at least quarterly, and the insurer will monitor the account performance daily using a formula based on which the insurer may direct the Sponsor to reallocate account assets to or from a specified fixed income mutual fund. The certificate owner, however, is described in the rulings as the legal owner of all assets in the investment account.

The group contract, as noted above, will provide a guaranteed lifetime withdrawal benefit ("GLWB") for each certificate owner that is linked to that owner's investment account. The GLWB will be conditioned on the owner not withdrawing more than a specified annual income amount from the account each year. The crux of the GLWB promise is that if withdrawals conform to this requirement but the account nonetheless is exhausted during the life of the owner (or the beneficial owner in the case of an entity-owned certificate), the insurer will begin paying the owner an "annual benefit." This annual benefit will consist of a series of periodic payments equal to the specified annual income amount, and these payments will continue for the owner's remaining life. A joint and survivor version of this benefit will also be available for the owner and his or her spouse. The taxpayer seeking each ruling represented that this payout will comply with the distribution-at-death requirements imposed by section 72(s).

The initial annual income amount specified for a certificate owner will be determined by applying a "withdrawal factor" to a "withdrawal base" when that owner makes the first withdrawal from his or her investment account. The withdrawal base will be determined daily by reference to market values combined with a "guaranteed increase rate" and a "guaranteed base increase." A certificate owner's annual income amount will decrease only if the owner takes a withdrawal from the account in excess of that amount, in which case the annual income amount will reduce proportionately. The certificate also will entitle the owner to apply his or her account's value to purchase a more traditional stream of annuity payments, at rates specified in the group contract.

INDIVIDUAL TAX ISSUES ADDRESSED IN THE NEW AND PRIOR RULINGS

In its ruling issued to the prospective certificate owner (PLR 201117013), the IRS reached the following conclusions, each of which is either identical or similar to conclusions that the IRS reached in the earlier rulings (some of those earlier rulings also addressed other issues not dealt with in the new rulings):

(1) The group contract and each certificate under it will constitute an annuity contract for purposes of section 72.

(2) The annual benefit provided under the contract, and any traditional annuity payments provided, will be taxable as "amounts received as an annuity" using an "exclusion ratio" under section 72(b).

(3) For purposes of sections 72(c)(1) and 72(e)(6) (defining "investment in the contract"), the "aggregate amount of premiums or other consideration paid" for a certificate will equal the sum of all periodic charges paid for it plus any proceeds paid to the insurer upon liquidation of the investment account in consideration for annuity payments.

(4) Dividends that the certificate owner receives from the assets in the investment account will not fail to be treated as "qualified dividend income" within the meaning of section 1(h)(11)(B) merely because the owner also holds a certificate under the group contract.

(5) The ownership of both the certificate and the investment account will not be treated as a straddle under section 1092.

(6) The annual benefit will not constitute insurance or other compensation for any prior deductible losses in the account for purposes of section 165.

NEW ISSUES AFFECTING THE CERTIFICATE OWNER

In addition to the foregoing, PLR 201117013 addressed two issues pertinent to the certificate owner that were not involved in the earlier IRS rulings.

First, the new ruling concludes that the "tax benefit doctrine" will not operate to tax the portion of annual benefits provided under the contract that otherwise would be excludable as a return of the certificate owner's investment in the contract. Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the earlier deduction was based. The ruling states that the non-taxable

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return of the "investment in the contract" *via* the exclusion ratio applicable to the annual benefit might be recharacterized as taxable income under the tax benefit rule if it were viewed as an event that is fundamentally inconsistent with the premise on which an earlier deduction was claimed with respect to losses in the account. The ruling concludes, however, that this will not be the case, employing the same reasoning used in support of the conclusion in item (6) above (regarding whether the annual benefit will constitute insurance or other compensation for any prior deductible losses in the investment account for purposes of section 165). In essence, the ruling reasons that the connection between any particular loss and the potential payment of annual benefits is too tenuous to "recapture" the prior tax benefit.

Second, the new ruling concludes that the existence of the investment account will not cause the group contract or the certificate to have a "cash value" or "cash surrender value" for purposes of section 72, and that the account itself will not otherwise be part of the contract or certificate for federal tax purposes. In reaching this conclusion, the ruling observes that section 72 does not define "cash value" or "cash surrender value." The ruling discusses how those terms have been defined more generally, and concludes that the account does not give rise to a cash value. In this regard, the ruling notes that the certificate owner can access the values in the investment account quite apart from the operation of the certificate but cannot "monetize" the certificate itself *via* withdrawals from it or by assigning or surrendering it. The ruling contrasts this arrangement with the so-called investment annuity described in Rev. Rul. 77-85, 1977-1 C.B. 12, which involved an annuity contract and a custodial account wherein a surrender of the contract would result in liquidation of the custodial account.

INSURANCE COMPANY TAX ISSUES

PLR 201117012, issued to the insurer, reached the following conclusions:

(1) The group contract and each certificate under it will constitute an annuity contract for purposes of section 72.

(2) The annual benefit and any traditional annuity payments will be taxable as "amounts received as an annuity" using an "exclusion ratio" under section 72(b).

(3) The investment account will not cause the contract or the certificate to have a "cash value" or "cash surrender value" for purposes of section 72, and the account will not otherwise be part of the contract or certificate for federal tax purposes.

(4) For purposes of sections 72(c)(1) and 72(e)(6), the "aggregate amount of premiums or other consideration paid" for a certificate will equal the sum of all periodic charges paid for it plus any proceeds paid to the insurer upon liquidation of the account in consideration for annuity payments.

As with the prior rulings on CDAs, these conclusions overlap with many of the IRS's conclusions reached with respect to certificate owners.

CONCLUDING OBSERVATIONS

Taken as a whole, the various private letter rulings issued to date appear to indicate that the IRS has become comfortable with the following key conclusions regarding the federal income tax treatment of CDAs and the GLWBs they provide:

(1) The products are treated as annuity contracts for federal income tax purposes and not as some other type of financial instrument, such as a derivative.

(2) The basic benefit payments made under the arrangement are treated as annuity payments taxable under section 72(b), applying an exclusion ratio determined using the contract charges as the investment in the contract.

(3) The CDA's interaction with the linked account does not interfere with the otherwise applicable tax treatment of the assets in the investment account, *e.g.*, the arrangement is not a straddle (which would defer the deduction of losses incurred in the account's investments).

Private rulings issued by the IRS, of course, do not constitute precedent and cannot be relied on by parties other than the taxpayers to whom they are issued.[3] Hence, as other insurers enter this market, there may well be further ruling activity along the lines we have seen thus far.

In addition, while the authors are not experts in the federal securities laws, we understand that the IRS's conclusion that the stand-alone withdrawal benefit is an annuity, with income taxed under section 72, also has significance for the treatment of the CDA under the Dodd-Frank Act (the "Act"). The Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have each approved the issuance of a joint proposed rule relating to the definition of "swap," "security-based swap," and "security-based swap agreement" under the Act. The proposed rule provides that insurance products meeting certain requirements and issued by insurers or other entities satisfying certain other requirements will not be regulated as swaps or security-based swaps under the Act. Additionally, under proposed interpretive guidance from those agencies, certain products issued by regulated insurance companies, including annuity products that are taxable under IRC section 72, will be considered insurance and not swaps or security-based swaps regardless of whether such instruments meet the specific requirements set forth in the proposed rule. In light of the IRS's conclusion in the various private letter rulings that stand-alone withdrawal benefits are annuity contracts taxable under section 72, such products would appear to fall within the scope of the SEC and CFTC proposed exception for annuity products as described above, subject of course to review of the SEC and CFTC guidance (and consultation with securities law counsel).

END NOTES

1 The earlier rulings, apart from PLRs 201105004 and 201105005, were PLRs 201001016, 200949036 and 200949007. The latter rulings were discussed in an article published in *Taxing Times* in May 2010. 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.

3 Section 6110(k)(3).

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DEFICIENCY RESERVES: THE CICADAS OF THE LIFE INSURANCE INDUSTRY

By Christian DesRochers

Deficiency reserves could be described as the "cicadas" of the life insurance industry. They have existed since the early years of the industry and periodically emerge from underground during the transition to new mortality tables, as existing tables become outdated because of improvements in mortality. Despite efforts on the part of the actuarial profession to eliminate them, they have continued to exist, although changing and evolving along the way. Deficiency reserves also have an interesting connection to the federal income taxation of life insurance companies. Beginning with the 1959 Act, they were excluded from the definition of life insurance reserves, a political decision which made sense in 1959, but which has added complexity to the taxation of life insurance companies since that time. Deficiency reserves were also indirectly responsible in part for the development of the 1984 Act. Nonguaranteed premium plans, which were developed to avoid deficiency reserves for a variety of nonparticipating products during the transition from the 1958 CSO Table to the 1980 CSO Table, led to the broad definition of policyholder dividends currently found in section 808 of the of the Internal Revenue Code (the "Code"). Under the 1959 Act rules, these amounts were not deductible for many stock life insurance companies, the so-called "Phase II negative" companies, one of many issues addressed by the 1984 Act. This article traces the tax treatment of deficiency reserves, beginning with the 1959 Act, illustrating how the decisions made in the development of the 1959 Act continue to affect the tax treatment of those reserves today.

DEFICIENCY RESERVES AND THE STANDARD VALUATION LAW

Traditionally, where the gross premium charged for a life insurance contract is less than the valuation net premium, a deficiency reserve based on the difference between the valuation net premium (P) and the gross premium (GP) has been required under valuation statutes. Dating to the early 20th century, section 85 of the Insurance Laws of New York provided:

> When the actual premium charged for an insurance by any life insurance corporation doing business in this State is less than the net premiums for such insurance computed according to the table of mortality and rate of interest prescribed in this article, such corporation shall be charged as a separate liability with the value of an annuity, the amount of which shall equal the difference between such premiums and the term of which in years shall equal the number of future annual payments due on such insurance at the date of the valuation.[1]

This had the effect of substituting the gross premium for the valuation net premium in the establishment of the statutory reserves. The relationship can be expressed as follows for a level premium whole life plan:

Basic Reserve: $A_{x+t} - P_x\, \ddot{a}_{x+t}$
Deficiency Reserve: $(P_x - GP_x)\, \ddot{a}_{x+t}$
Combined: $A_{x+t} - GP_x\, \ddot{a}_{x+t}$

As illustrated above, a net premium reserve is the present value of future benefits minus the present value of future net premiums. The argument for a deficiency reserve states that it is improper to deduct the total present value of net premiums if the gross premiums which are actually to be collected are less than those net premiums. That is, a deficiency reserve is merely a device by which the reserve is never permitted to be based on a prospective valuation premium to the extent that the premium will not be collected. Thus, the deficiency reserve requirement is regarded as a necessary element in a system of reserves where credit is taken for future net premiums. This logic carries an implication that the valuation mortality table is generally consistent with the pricing assumptions, with some degree of margins. However, the deficiency reserve problem has historically developed in circumstances where emerging mortality experience led insurance companies to charge gross nonparticipating premiums less than the valuation net premiums, which typically occurs during a transition in valuation tables. In this respect, a deficiency reserve can be characterized as an adjustment in reserves brought about by unrealistic actuarial assumptions. That is, assuming that product pricing is rational, the net premium can be more than the gross only if the mortality or interest basis, or both, are very conservative. If this is the case, the present value of the benefits will be greatly overstated, and this overstatement will more than offset the overstatement in the present value of future premiums.

During the drafting of the Standard Valuation Law in the 1940s, consideration was given to the problem of deficiency reserves. At that time, deficiency reserve requirements had existed by statute or practice for a great many years in many states. The committee drafting the statute was faced with an existing requirement which would have been quite difficult to remove. While "considerable study was given to the problem, and suggestions for changing its form were made, the end result was a continuance in the standard legislation of substantially the form of deficiency reserve then in existence in the various states."[2] Ultimately, a judgment was made not to raise the deficiency reserve issue out of fear that it would lead to opposition to the entire valuation law. There was a practical expedient to this decision as well, as the Standard Valuation Law also introduced the 1941 CSO Table, which would largely eliminate deficiency reserves on new issues, a theme that would be repeated again in the transition to the 1958 CSO Table.

THE 1959 ACT

With the continued improvement in mortality since the development of the 1941 CSO Table, deficiency reserves once again emerged in the latter half of the 1950s, creating pressure to either change the valuation law or replace the 1941 CSO Table with a more up-to-date table. Unlike participating insurance which could be issued at the valuation net premium because of the operation of the dividend scale, nonparticipating policies were once again being issued where the gross premiums were less than the net premiums according to the 1941 CSO Table. The emergence of deficiency reserves became a divisive force in the industry, not only between stock and mutual companies but also between established and newer, more lightly capitalized stock companies, who were not in a position to set up the required deficiency reserves to compete with the older companies issuing low-cost nonparticipating policies. The result was the development of the 1958 CSO Table, which was based on experience between 1950 and 1954. Since companies were moving to adopt product portfolios based on the new table in the late 1950s, the development of the 1959 Act occurred during the transition in mortality standards between the 1941 and 1958 CSO Tables.

This raised the issue of the treatment of deficiency reserves under the 1959 Act, particularly for smaller stock companies, who would be taxed on their gain from operations, known as the "Phase II negative" tax base. The legislative history makes the Congressional intent of excluding deficiency reserves clear, noting "these reserves will not be taken into account in determining gains from operations, and thus deficiency reserves which have been built up prior to 1958 will not produce an increase in the life insurance company's tax base under phase 2 when they decrease in years after 1957."[3] This was an early form of "fresh start," a technique more broadly used in the tax legislation of the 1980s.

A similar perspective was provided by Buist M. Anderson in his report on the effects of the 1959 Act:

> This new provision excludes deficiency reserves from the definition of "life insurance reserves." If the industry (meaning here the stock companies because mutuals, generally speaking are not concerned with deficiency reserves) had so desired and acted accordingly, we probably could have had the law so drafted that deficiency reserves would have been treated as allowable reserves. The disadvantage, of course, would be that such reserves existing December 31, 1957 would, in time, come back through earnings and would then be taxed under Phase II. The assumption is that deficiency reserves will be of less importance in the future because of the adoption of the new mortality table and that such reserves will, generally speaking, decrease and, in time, disappear.[4]

In anticipation that the exclusion of deficiency reserves would in the aggregate reduce taxable income, the decision to exclude deficiency reserves from the definition of life insurance reserves was incorporated into the 1959 Act, thus setting the treatment that remains today. This had the effect of increasing the taxes on companies taxed on a net investment income tax base, as deficiency reserves were excluded from the calculation of required (reserve) interest, thus increasing the taxable amount. This affected the large stock companies on the Phase II positive tax base, who held deficiency reserves, and to a

The emergence of deficiency reserves became a divisive force in the industry, not only between stock and mutual companies but also between established and newer, more lightly capitalized stock companies …

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lesser degree mutual companies under Phase I, because of their generally lower deficiency reserves which were limited principally to term insurance plans.

Years later, as deficiency reserves were once again emerging as an issue for the industry, in reflecting on that judgment in the 1959 Act one commentator remarked:

> Deficiency reserves seems to me like a good example of poor strategic tax planning back in the 1950s. The industry was given a choice when the 1959 act was being developed of either excluding or including deficiency reserves as life insurance reserves. The industry chose to exclude them because they were expected to run off and excluding them would reduce the Phase 2 tax that would be paid primarily by the stock companies. I think if the industry had done a better job of strategic tax planning, it might have foreseen that deficiency reserves would not disappear in a few years but there would be further deficiency reserves as mortality improved and premiums came down. Unfortunately the industry did not do this. As a result, we have had a reserve excluded which would have been much better included.[5]

THE 1976 AMENDMENTS TO THE STANDARD LAW

The 1959 Act defined deficiency reserves for any contract consistent with the statutory definition at the time as "that portion of the reserve for such contract equal to the amount (if any) by which—(A) the present value of the future net premiums required for such contract, exceeds (B) the present value of the future actual premiums and consideration charged for such contract."[6]

The 1976 amendments removed any references to deficiency reserves, but required additional reserves in situations where "the gross premium charged by a company on a policy is less than the valuation net premium for the policy or contract calculated . . . using the minimum valuation standards of mortality and interest."[7] The revised requirements defined the minimum required reserve as the greater of two values:

(1) The present value of future benefits less the present value of future valuation net premiums calculated by the method (commissioners or net level) actually used in computing the reserve for that policy but using the minimum valuation standards of mortality and rate of interest and substituting the gross premium in the reserve calculation for each contract year where it was less than the valuation net premium.
(2) The reserve calculated according to the mortality table, rate of interest and valuation method actually used for the policy.

This approach permitted a company to use a stronger basis for valuation than the minimum required by law without being forced to put up additional reserves if its gross premiums are less than actual net valuation premiums but more than the minimum net valuation premiums specified by law. However, it also created an inconsistency between the valuation law and the Code definition of deficiency reserves.

DIVIDENDS AND NONGUARANTEED PREMIUMS

By the mid-1970s, as was the case when the 1958 CSO Table replaced the 1941 CSO Table, growing deficiency reserve problems for certain plans of life insurance again became a problem due to the level of mortality underlying the 1958 CSO Table compared to the then-current mortality rates. The 1980 CSO Tables were developed by the Special Committee to Recommend New Mortality Tables for Valuation in 1979, to replace the existing 1958 CSO Tables as the minimum standard for valuation.[8] At the same time, nonguaranteed premium products began to emerge as a solution to the deficiency reserve dilemma being faced by most stock life insurance companies. Under these plans, the current level of gross premiums would be guaranteed for an initial period, often as short as a year. Because the company had the right to increase the premium after the initial guarantee period, deficiency reserves were not required after the initial guarantee period if the maximum premium was equal to or greater than the valuation net premium. This was particularly important for nonparticipating plans with nonsmoker or preferred risk discounts which had also begun to emerge in the market. Although the deficiency reserves for these plans generally would be reduced by the adoption of the 1980 CSO, in some cases they would not be completely alleviated as deficiency reserves would still be required due to the low premiums for select classes of insureds.

However, the characterization of the difference between the actually charged premium and the maximum premium as a dividend for the company's federal income tax emerged as an issue. Under Regulation section 1.811-2, "the term (dividend) includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management." The regulation further states, "similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company." Thus, it was not surprising that nonguaranteed elements would be classified as dividends for company income tax. This issue was of great significance to "Phase II negative" companies, that is, companies whose gain from operations before deductions is less than taxable investment income. Because deductions for dividends to policyholders were limited to $250,000 for companies in that tax situation, most if not all of the difference between the actual premium charged and the maximum premium would result in an increase to the gain from operations without a corresponding increase in allowable deductions for dividends to policyholders. This created a significant competitive issue for those companies, as neither the dividends nor deficiency reserves were deductible for those companies.

THE 1984 ACT

The 1984 Act addressed the issue of nonguaranteed elements by making policyholder dividends, broadly defined, deductible in computing life insurance company taxable income (subject to former section 809, since repealed). For many products, this has eliminated a deficiency reserves issue, as the guaranteed premium is set equal to or near the valuation net premium.

Congressional intent in the 1984 Act was to continue to disallow a deduction for "deficiency reserves." The DEFRA Blue Book noted:

> The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under prior law or whether the NAIC prescribed method otherwise requires a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).

The limitation was enacted as section 807(d)(C)(3), which provides that "no additional reserve deduction" is allowed for deficiency reserves, but defines the deduction in terms of "any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit." The statutory language appears to prevent the application of the statutory "minimum reserve" method in the development of federally prescribed reserves. In effect, this would not permit a "deficiency reserve" tax reserve component.

Section 816(h) excludes deficiency reserves from "life insurance reserves," without defining deficiency reserves. This provision was not in the original 1984 language, but was added in the subsequent Technical Corrections as part of the Tax Reform Act of 1986. In general, deficiency reserves appear today only in limited circumstances. However, they are an element of *The Valuation of Life Insurance Policies Model Regulation* (Regulation XXX), creating a nondeductible element of the XXX reserves.

The final issue relative to deficiency reserves is their treatment in the "statutory cap." Section 807(d) provides that the deductible reserve for a life insurance contract is the greater of net surrender value or the Federally Prescribed Reserve (FPR) calculated under prescribed interest rate and mortality assumptions, but in no event can the tax reserve exceed "aggregate statutory reserves" (*i.e.*, the statutory cap). On audit, the IRS has raised the issue of whether deficiency reserves are a part of the statutory cap, a position strongly held by the life insurance industry.[9] The IRS Priority Business Plan for 2010–2011 includes providing guidance "clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6)," (*i.e.*, the statutory cap).

The statutory language appears to prevent the application of the statutory "minimum reserve" method in the development of federally prescribed reserves.

CONCLUSION

The history of the tax treatment of deficiency reserves illustrates how decisions made in the development of life insurance tax laws may have implications far beyond what was anticipated by the drafters of the statutes. Although intended

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to reduce the overall tax on small stock life insurance companies (who were the majority of Phase II negative companies), as discussed above, the decision has had far-reaching consequences, more than 50 years later. It also continues to create controversy over the inclusion of deficiency reserves in the statutory cap. The introduction of nonguaranteed premiums as a way to minimize deficiency reserves also led in part to the emergence of the current section 808 definition of dividends, as well as the treatment of dividends in determining taxable income under the 1984 Act. If there is a lesson to be learned, it is simply that before practical expedients are introduced into the tax code, they should be judged in a broader and perhaps a more theoretical context, and not as a short-term fix to an immediate problem.

The views expressed are those of the author and do not necessarily represent those of Ernst & Young LLP.

END NOTES

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7 Standard Valuation Law, Section 8, Reserve Calculation—Valuation Net Premium Exceeding Gross Premium Charged. NAIC Model Regulation Service, July 2010.

8 *Transactions of Society of Actuaries* 1981 Vol. 33 Report of The Special Committee To Recommend New Mortality Tables For Valuation.

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ACLI UPDATE

ACLI ASKS TREASURY TO REVIEW SEVERAL INSURANCE TAX REGULATIONS PURSUANT TO PRESIDENT OBAMA'S EXECUTIVE ORDER ON REGULATORY REFORM

By Walter Welsh, Pete Bautz and Mandana Parsazad

In response to Executive Order 13563 (the "Executive Order") issued by President Obama on Jan. 18, 2011, the Treasury Department ("Treasury") issued a request for information ("RFI") on March 29, 2011. The RFI invited comments by April 29, 2011, about which Treasury regulations should be modified, expanded, streamlined or repealed in order to make the Department's regulations more effective, less burdensome or both. The RFI particularly encouraged commenters to respond to a series of questions, including the following question: "Are there Treasury rules that are outdated or contrary to recently enacted statutes, or otherwise in need of updating?"

On April 29, the American Council of Life Insurers (ACLI) filed a request with Treasury pursuant to the Executive Order and RFI that it review and update as recommended the following regulations impacting the tax treatment of life insurance companies or their products:

- The life/nonlife consolidated return regulations;
- The rules for correcting failures of variable life insurance or annuity contracts due to inadvertent violations of the diversification rules of § 817(h); and
- The current Form 1099 reporting rules for controlled foreign corporations ("CFCs") of U.S. life insurers.

This article provides more details about the nature of the ACLI's request.

REQUEST TO UPDATE THE LIFE/NONLIFE CONSOLIDATED RETURN REGULATIONS

Regulation § 1.1502-47 provides extensive rules covering life/nonlife consolidated returns. These regulations were originally promulgated in 1983, and although there have been amendments over the years, their basic structure remains unchanged. In 1984, the Deficit Reduction Act substantially changed the method for taxing life insurance companies. The life/nonlife consolidated return regulations predate that law, however, and do not reflect the changes to life insurance company taxation that have occurred over the last 25 years.

ACLI's April 29 Executive Order submission renewed prior ACLI requests—most recently in 2009—that Treasury make the consolidated return regulations for affiliated groups including life insurance companies more consistent with current statutory provisions and less complex. In particular, the ACLI asked that:

- Cross-subgroup carrybacks of capital and life operating losses be permitted by removing the prohibitions on the cross-subgroup carryback of capital losses or life operating losses while retaining the portion of the regulations that excludes the cross-subgroup carryback of a nonlife consolidated net operating loss ("CNOL") against life income.
- One subgroup's capital losses be allowed to offset the other subgroup's capital gain before such gains are offset by ordinary losses of the gain subgroup by amending the life-nonlife rules to conform to the normal consolidated return rule that allows capital losses to offset capital gains.
- The life-nonlife rules be amended to apply the general consolidated return *pro rata* loss absorption rules within a nonlife subgroup. In the loss year, the portion of the CNOL allocated to an ineligible nonlife loss member should be determined on a *pro rata* basis under the rules of Treas. Reg. § 1.1502-21(b), and in the carryback or carryover years, the allocated loss should be utilized on a *pro rata* basis against the income of all members of the nonlife subgroup.

REQUEST TO MODIFY THE RULES FOR CORRECTING FAILURES OF VARIABLE LIFE OR ANNUITY CONTRACTS DUE TO INADVERTENT VIOLATIONS OF THE DIVERSIFICATION RULES OF SECTION 817(H)

During 2007, the ACLI worked with the Internal Revenue Service (IRS) to develop streamlined correction procedures for inadvertent failures of variable contracts under § 817(h). That process resulted in the issuance of Rev. Proc. 2008-41 related to corrections under Section 817(h). Rev. Proc. 2008-

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41 requires that if there is an asset diversification failure, the insurer must submit a request for an IRS ruling and pay a toll charge. The toll charge is calculated as (1) the tax payable on the income on the failed contracts, or (2) 100 percent of the amount of the excess over the applicable limit(s), capped at the lesser of $5 million or 5 percent of the total value of the non-diversified segregated asset account. The cap is determined separately for each segregated asset account that contains nondiversified assets. Rev. Proc. 2008-41 did not contain a *de minimis* rule.

In its submission, ACLI noted that the RIC Modernization Act of 2010 amended section 851 to provide a *de minimis* exception to the diversification requirements under section 851. This exception provides that a corporation is considered to meet the diversification requirements for any quarter during which it is technically out of compliance if: (1) the failure to comply is due to the ownership of assets, the total value of which does not exceed the lesser of (i) 1 percent of the total value of the corporation's assets at the end of the quarter for which the measurement is done, or (ii) $10 million; and (2) the corporation disposes of the assets in order to meet the requirements within six months after the last day of the quarter in which the failure was identified. Violations falling within the *de minimis* exception can be corrected without the necessity of any reporting to the IRS or the payment of any toll charge.

ACLI requested that the correction procedures available under section 817(h) and the regulations thereunder be amended to provide for a *de minimis* exception consistent with the *de minimis* exception approved by Congress in the RIC Modernization Act. Significantly, ACLI observed that this change could be made without further legislation, since Treasury has been given specific authority under section 817(h)(1) to prescribe regulations determining when an account is adequately diversified. Using this authority to create a *de minimis* exception to the diversification rule would be particularly appropriate given that the section 817(h) rules are based at least in part on, and are similar in many respects to, the rules in section 851.

REQUEST TO CLARIFY THAT THE CURRENT FORM 1099 REPORTING RULES FOR CFCS OF U.S. LIFE INSURERS DO NOT APPLY TO LIFE INSURANCE COMPANIES PRIOR TO THE JAN. 1, 2013 EFFECTIVE DATE FOR CHAPTER 4 REPORTING

Under the current regime, CFCs are required to document the status of their customers, and to file information returns for income payments to customers that are known or presumed to be U.S. persons. Thus, for CFCs of U.S. life insurers, payments made to U.S. customers, or to customers whose status cannot be determined and are presumed to be U.S. persons, are reportable on Forms 1099.

As a result of the compliance rules, a CFC must either: (i) file annual Forms 1099 for all of their existing and future customers, since all of them would be presumed to be U.S. taxpayers in the absence of documentation, or (ii) insert an onerous legend on all application and/or other distribution forms warning potential customers or policyholders that "a false statement or misrepresentation of tax status by a U.S. person could lead to penalties under U.S. law." Insertion of a legend on application forms has problems aside from placing CFCs of U.S. insurers at a competitive disadvantage vis-à-vis their foreign-owned competitors. There are legal and regulatory obstacles to directing existing customers to sign a statement or to inserting such a legend on future applications. Alternatively, for companies that could not comply with the legend requirement for part or all of their existing or future contracts due to commercial, legal or regulatory reasons, the number of IRS information returns required could be very large and of very little assistance to the IRS.

ACLI noted that the Treasury rules were outdated and effectively subsumed by the Foreign Accounts Tax Compliance Act ("FATCA"), a recently enacted statute. In light of FATCA's enactment, and the indication in Notice 2010-60 that CFCs will not be treated as deemed compliant pursuant to section 1471(b)(2), ACLI recommended that CFCs of U.S. life insurers be treated as having complied with all their reporting obligations under the Internal Revenue Code (the "Code") if they fulfill the requirements of chapter 4 *(i.e.,* sections 1471 to 1474 of the Code) as finally proposed for foreign life insurers. ACLI also requested clarification that the current Form 1099 reporting rules not apply to life insurance companies prior to the Jan. 1, 2013 effective date for FATCA reporting.

In addition to its April 29, 2011 Executive Order request, on June 1, 2011, ACLI submitted a request to the IRS pursuant to Notice 2011-39, asking that the IRS include the modification of the three regulations referenced above on its 2011–2012 Priority Guidance List. We will update *Taxing Times* readers if the Treasury or the IRS decides to address the modification of these regulations through either the Executive Order or Priority Guidance processes.

T³: *TAXING TIMES* TIDBITS

AFTER GOING 0 FOR 6 IN THE UNITED STATES TAX COURT, WILL TAXPAYERS FINALLY GIVE UP THE FIGHT?

By Daniel Stringham

Consider the following common fact pattern. Taxpayer/policyholder purchases a universal life insurance policy.[1] Under the terms of the policy the holder may borrow from the insurance company, using the policy as security for the loan, up to 90 percent of the policy's cash surrender value. The policy has a stated, and reasonable, loan interest rate. Interest accrues on the loan and is automatically added to the loan balance if annual interest payments are not made to the insurance company. At a time when the policy has cost basis of $10,000 and cash value of $15,000, meaning the policy has $5,000 of embedded tax gain, policyholder takes a $13,500 policy loan from the insurance company. We will assume that policyholder does not make additional premium or loan payments and cash surrender value remains constant. As the loan balance approaches the policy's cash surrender value, insurance company sends a notice indicating that the policy will lapse within 60 days unless policyholder makes either a premium or loan interest payment. Policyholder does not respond to this notice and the policy lapses shortly thereafter when the outstanding loan balance ($15,000) equals the policy's cash surrender value ($15,000). Insurance company then files a Form 1099-R listing $5,000 of taxable income, representing the difference between the $15,000 loan and $10,000 cost basis.

Is there an actual or deemed distribution from a life insurance policy when a policy lapses with an outstanding loan? Is the tax treatment dependent upon whether the policyholder actually receives any cash upon the lapse? Did the insurance company properly calculate tax gain? Since early 1999, six such cases have gone before the United States Tax Court, and, in each instance, the taxpayer lost the case and did so regardless of whether the policyholder actually received any cash upon the lapse. As a consequence, and consistent with the manner in which the insurance companies calculated and tax reported the lapses, taxpayers were required to include in income the difference between the outstanding loan and the policy's cost basis. *See Atwood v. Commissioner,* T.C. Memo. 1999-61 (March 1999), where the court held: "[a] contrary result would permit policy proceeds, including previously untaxed investment returns, to escape tax altogether." *See also Reinert v. Commissioner,* T.C. Summary Opinion 2008-163 (Dec. 2008), *Barr v. Commissioner,* T.C. Memo. 2009-250 (Nov. 2009), *McGowen v. Commissioner,* T.C. Memo. 2009-285 (Dec. 2009), *Sanders v. Commissioner,* T.C. Memo. 2010-279 (Dec. 2010) and *Brown v. Commissioner,* T.C. Memo. 2011-83 (April 2011). The victories were so one-sided in four of these cases that the IRS successfully assessed accuracy-related penalties. *See Atwood, Reinert, Barr* and *Brown.* Even more telling about the strength of the government's position is the fact that in two of the accuracy-related penalty cases the plaintiffs were attorneys and presumably put up a strong defense. *See Barr* and *Brown*.

What is it about a policy lapse with a loan that generates so much litigation and countless phone calls to insurance companies each year when Forms 1099-R are mailed to policyholders? Something is clearly confusing policyholders from a tax perspective when it comes to these transactions. Beyond asserting unsuccessfully that there is nothing to tax in the absence of an actual cash distribution to the policyholder upon the lapse, let's examine the extent of the confusion by briefly reviewing some of the other unsuccessful arguments taxpayers/policyholders have made in an attempt to escape taxation. For example, in *Atwood* taxpayers argued (i) the amounts in question merely represent paper transactions on the books of the insurance company, (ii) borrowing against a

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policy is just borrowing your own money, and (iii) capitalized interest on the loan increases cost basis. *Reinert* suggested that a "surrender" is required under applicable statutes and regulations in order to have a taxable event but a lapse with a loan is a "termination" and thus not subject to taxation. *Barr* suggested "maybe it's time for a change in the law," and, in any event, the character of any income should be capital rather than ordinary income. The taxpayers in *McGowen* argued that a lapse with an outstanding loan is not taxable because the transaction should be characterized as the discharge of indebtedness under IRC section 108. *Sanders* said he just did the math in his head and thought the insurance's company's mathematics were way off and also he received "draws" from the contract rather than loans. Finally, in *Brown,* which is the most recent case on the topic, taxpayers did not include any income from the transaction on their tax return because they simply concluded, without consulting the insurance company or performing independent analysis, that the insurance company incorrectly analyzed the termination of the policy (which might explain why the court imposed a substantial understatement penalty).

Taxpayers/policyholders could save themselves a great deal of time, energy and litigation costs by focusing instead on the mechanics of a policy loan. Understanding the mechanics of a policy loan helps to explain and clarify the tax treatment. First, and perhaps the most critical point to understand, the loan does not come from the life insurance policy itself but instead is a loan from the insurance company's general account. Second, the loan is secured by the policy's cash surrender value. Third, under the terms of the life insurance policy, the loan is a bona fide loan, with a bona fide interest rate, which is respected by the courts. Fourth, when the policy lapses due to the size of the loan, the insurance company's general account is paid back by claiming the policy's cash surrender value. In effect, the insurance company pays the cash surrender value to the policyholder, which is the equivalent of a taxable distribution upon surrender on the difference between the loan and the policy's cost basis, and the policyholder then transfers the cash surrender value to the insurance company in order to pay back the loan. Utilizing the surrender proceeds, i.e., the policy's cash surrender value, to pay back the insurance company, explains why policyholders generally do not receive any net cash at the time of lapse.

Given the emerging pattern of litigating these types of cases, it seems likely that other policyholders will follow suit and challenge the taxation of policy lapses with loans. However, given the state of the law, it also seems equally clear these policyholders will lose in court and likely pay accuracy-related penalties as well. In light of the law, the better course of action seems to be a detailed discussion with the insurance company in order to gain a better understanding of the mechanics of such loans and how these mechanics support the tax treatment.

Author's Note: After the article went to press, a seventh taxpayer lost a similar case in the United States Tax Court. See *Ledger v. Commissioner*, T.C. Memo. 2011-183 (Aug. 2, 2011). In this case, an endowment contract matured with an outstanding loan and the court ruled there was a constructive distribution of the policy's proceeds to pay back the loan, resulting in income to the extent the distribution exceeded the policy's cost basis.

END NOTES

1 For purposes of this exercise, we will assume the policy is not a Modified Endowment Contract under section 7702A of the Internal Revenue Code of 1986, as amended.

LOSS ADJUSTMENT EXPENSES FOR LIFE INSURANCE COMPANIES

By Peter H. Winslow

At the May 2011 Insurance Tax Seminar sponsored by the Federal Bar Association, there was a discussion on the Life Audit Update panel about Internal Revenue Service (IRS) auditors discovering that some taxpayers "erroneously" include loss adjustment expenses ("LAE") in life insurance reserves. Some of the panelists expressed justifiable surprise that this has been an issue. In general, LAE are not deductible by life insurance companies on a reserve basis. Expenses incurred in settling claims by a life insurance company are deductible as general business expenses under I.R.C. § 805(a)(8). General business expenses are deductible using the accrual method of accounting under I.R.C. § 811(a). Moreover, life insurance reserves as defined in I.R.C. §816(b) do not include reserves for general business expenses, and I.R.C. § 807(d), which specifies how deductible life insurance reserves are computed for tax purposes, makes no reference to LAE.

What could be the issue that is arising on audit? My guess is that it relates to LAE on cancellable disability income policies. As a result of changes made to the Internal Revenue Code (the "Code") by the Tax Reform Act of 1986 ("1986 Act"), loss reserves for property-casualty lines of business are required to be discounted under I.R.C. § 846. Before the 1986 Act, nonlife insurance companies were entitled to deduct LAE on a reserve basis for tax purposes on the theory that claim-adjustment expenses are closely related to unpaid losses and considered in measuring underwriting income. To make sure that deductible LAE reserves are subject to discounting along with claim reserves, I.R.C. § 846(f)(2) was added to the Code to provide that "[t]he term 'unpaid losses' includes any unpaid loss adjustment expenses shown on the annual statement." Ordinarily, this provision would have little application to life insurance companies because they generally do not report material amounts of unpaid losses or LAE on the annual statement for life insurance contracts. However, LAE relating to disability income policies can be material and are required to be reported on the annual statement by SSAP No. 55, para. 6.c.

Reserves for cancellable disability income policies are not life insurance reserves as defined in I.R.C. § 816(b) and are not directly subject to the recomputation rules of I.R.C. § 807(d). Instead, for life companies, claim reserves on cancellable policies are classified as unpaid losses under I.R.C. § 807(c)(2). As such, they are unpaid losses subject to the loss discounting rules of I.R.C. § 846, and include LAE by reason of I.R.C. § 846(f)(2). There is a special rule in I.R.C. § 846(f)(6) for accident and health insurance lines of business that provides that unpaid losses relating to disability income should be computed using the general rules prescribed under the life insurance reserve rules of I.R.C. § 807(d) applicable to noncancellable accident and health insurance contracts, with some specified modifications. Consequently, it appears from the face of the statute that I.R.C. § 846 requires disability income claim reserves (including LAE) to be computed as if these reserves were life insurance reserves. And, this is so whether the taxpayer is a life or nonlife company.

Not so fast. When it came to the attention of the drafters of the 1986 Act that the inclusion of LAE as part of unpaid losses could change the long-standing accrual method of accounting for LAE for life insurance companies, a sentence was added to the legislative history in an attempt to prevent this result. The Conference Report states:

> Similarly, life insurance companies are not intended to be permitted to deduct loss adjustment expenses by virtue of the application of the property and casualty discounting methodology with respect to cancellable accident and health insurance business, if any, of such companies.

So, here we have a situation where, on the one hand, the statute appears to require that LAE be included in unpaid losses and deducted as if they were life insurance reserves, yet, on the other hand, the legislative history states that this was not intended. It is likely that this conflict between the statute and the legislative history is the issue that the Federal Bar Association panel said has arisen on audit.

IRS QUESTIONS SEPARATE ACCOUNT INVESTMENTS IN GROUP TRUSTS

By Joseph F. McKeever, III

A group trust is an investment vehicle in which the assets of qualified employer-sponsored retirement plans, typically sponsored by unrelated employers, are pooled. A group trust is generally exempt from income tax, based on the tax-exempt status of the employer-sponsored plans which invest in the group trust, provided that certain requirements set forth in Revenue Ruling 81-100[1] are satisfied. In December 2010, the Internal Revenue Service (IRS) released Rev. Rul. 2011-1[2] modifying the rules for group trusts described in Rev. Rul. 81-100. Significantly, Rev. Rul. 2011-1 requests comments on whether "annuity contracts and/or other tax-favored accounts held by plans described in § 401(a) or § 403(b), such as pooled separate accounts supporting annuity contracts that are treated as trusts under § 401(f), should be permitted to invest in the group trusts described in [the] revenue ruling."[3]

The IRS's request for comments suggests that it questions whether separate accounts supporting variable annuity con-

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tracts held by tax-qualified plans and 403(b) plans may invest in group trusts under current law. The IRS inquiry surprised many life insurance companies and their advisors because such investment structures have been used for many years and are fairly commonplace. The American Council of Life Insurers, the Committee of Annuity Insurers and others have filed comment letters expressing the view that separate accounts are and should be permitted investors in group trusts. The key points made by these commentators are as follows:

- The use of group trusts as investment options in section 401(a) plans that are funded through group annuity contracts is widespread and largely attributable to section 401(f), which treats annuities as qualified trusts under section 401 if the annuity would, except for the fact that it is not a trust, constitute a qualified trust. The obvious purpose underlying section 401(f) is to create parity between trusts and annuities. In this regard, the legislative history of the Employee Retirement Income Security Act of 1974 ("ERISA"), which amended section 401(f) to treat annuities as qualified trusts, indicates that the change was made "in order to permit the participation of the insurance industry," to "enhance competition" and to "open the field to other types of enterprises that wish to engage in it."[4]

- Treasury regulation section 1.401(f)-1(c) states that an annuity contract which satisfies the applicable requirements of section 401(f) "is treated as a qualified trust for all purposes of the Internal Revenue Code" and "as a separate legal person which is exempt from the income tax under section 501(a)." Rev. Rul. 81-100 in turn provides that a trust that is qualified under section 401(a) and exempt under section 501(a) is a permitted investor in a group trust. Given the clear statutory and regulatory treatment of annuity contracts described in section 401(f), it was apparent, at least prior to Rev. Rul. 2011-1, that pooled separate accounts were permitted investors in group trusts, provided that the separate account otherwise satisfied the applicable requirements of Rev. Rul. 81-100.[5]

- Permitting qualified plan separate accounts to invest in group trusts is consistent with the purpose underlying the group trust rules. Rev. Rul. 56-267, the predecessor of the current rulings, states that the ruling was requested because many plans "are insufficient in size to permit a satisfactory diversification in the investment of their funds. In order to provide such diversification, a number of these trusts have been and are interested in pooling some or all of their funds, solely for investment purposes, in a group trust."[6] Similarly, small plans often utilize a group annuity contract platform for their 401(k) plans in order to pool assets in the insurer's separate account and thereby obtain economies of scale. These economies of scale are obtained by investing in underlying pooled investments, including a group trust.

- There is nothing inherent in the structure, operation or legal status of a pooled separate account, or in the relationship between the adopting plan, the separate account and the underlying group trust, that warrants different treatment for qualified plan separate accounts and qualified trusts under Rev. Rul. 81-100. As modified by Rev. Rul. 2011-1, a group trust must satisfy eight requirements, all of which can be satisfied by a separate account investing in a group trust.

- There are important policy reasons for allowing qualified plan separate accounts to invest in group trusts. Pooled separate account investments in group trusts are an important part of many 401(k) plans that utilize a group annuity contract platform. Group annuity contract platforms are particularly attractive for small and mid-size plans because the contracts provide for a bundle of services. These contracts also allow for the pooling of small plan assets and therefore access to a universe of investments that may not otherwise be accessible to such plans. Many of these investments are nonregistered investments that are offered only through group trusts. One notable type of investment that is frequently accessed through a separate account is a stable value fund. Also, treating trust platforms more favorably than group annuity platforms is inconsistent with encouraging plans to provide lifetime income options for their participants. Group annuity contracts invariably offer annuity forms of distribution while such forms of payout are much less common among trusteed plans. It does not make retirement policy sense to preference trusts over annuities.

The commentators also noted that adverse treatment for qualified plan separate accounts could have substantial implications. If separate accounts are not permitted investors in group trusts, it would mean that each of the group trusts that have permitted separate account investments are not group trusts within the ambit of Rev. Rul. 81-100. Although the precise consequences associated with a failure to satisfy the requirements of Rev. Rul. 81-100 are not clear, it appears that every plan invested in one of these group trusts—whether or not invested through a pooled separate account—would have its tax-qualified status thrown into question. Thus, not only would the plans that are invested in group trusts through insurance company separate accounts be in jeopardy, but every plan that is invested in a group trust with a separate account investor would be potentially tainted.

As of the time this is being written, there has been no further word from the IRS regarding investment by qualified plan separate accounts in a group trust. The industry commentators all clearly believe that the existing requirements of Rev. Rul. 81-100 serve to set appropriate parameters on the types of separate accounts that may invest in a group trust. In addition, one commentator suggested some clarifications of the existing requirements that could be made. (The commentator also urged a transition period to allow for any necessary amendments to be made to the contracts and related documents to avoid the uncertain, but potentially severe, tax consequences that would flow from a determination that separate accounts are not permitted investors in group trusts.) Given the importance of this issue to qualified plans, employee participants, insurers and the IRS, one can reasonably expect it to be the subject of further careful thought and additional guidance from the IRS.

END NOTES

1. 1981-1 C.B. 326, clarified and modified by Rev. Rul. 2004-67, 2004-2 C.B. 28.
2. 2011-2 I.R.B. 251.
3. All section references are to the Internal Revenue Code of 1986, as amended, unless specified otherwise.
4. H.R. Rep. 93-807 at 4826 (Feb. 21, 1974).
5. Rev. Rul. 2004-67 identified custodial accounts that fund section 401(a) plans, along with trusts, as permitted investors. However, in the absence of any reference to annuities treated as trusts under section 401(a) and given the informal guidance (private letter rulings and determination letters), this reference to favorable tax treatment for custodial accounts did not cause most observers to question that pooled separate accounts were permitted investors in group trusts.
6. 1956-1 C.B. 206, superseded by Rev. Rul. 81-100.

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