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DO WE FINALLY HAVE GUIDANCE ON SEPARATE ACCOUNT DRD?

By Susan J. Hotine

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The Internal Revenue Service (IRS) recently released Rev. Rul. 2014-7,[1] which addresses what is the amount of life insurance reserves taken into account under I.R.C. § 807 for a variable contract where some or all of the reserves are accounted for as part of a life insurance company's separate account reserves. Perhaps more important than what this ruling addresses is what it does not address. Rev. Rul. 2014-7 merely republishes the first, perhaps noncontroversial, holding of Rev. Rul. 2007-54[2] relating to the tax reserve amount for a variable contract. Rev. Rul. 2007-54 included a second holding, however, that stunned the industry with its conclusion that required interest for separate account reserves (which ultimately determines the company's share of the dividends-received deduction ("DRD")) should be calculated using the applicable federal interest rate.[3] This second holding would have had a significant negative financial impact on variable contract writers because following it would result in a substantial diminution to, if not elimination of, a company's share of the separate account's available DRD. The possibility of this negative financial impact was avoided by the publication of Rev. Rul. 2007-61,[4] which suspended Rev. Rul. 2007-54 and provided that the IRS would work on further guidance. Since 2007, every Priority Guidance Plan released by the Treasury Department and the IRS has included an item for "Revenue Ruling [or Guidance] on the determination of the company's share and the policyholders' share of the net investment income of a life insurance company under § 812." Rev. Rul. 2014-7 states that Rev. Rul. 2007-54 is modified and superseded, and that Rev. Rul. 2007-61 is obsoleted.

The first issue for consideration is: What does it mean when a ruling is modified and superseded? The IRS uses specific terms for explaining the effect that rulings have on previous rulings. In the "Definition of Terms" introduction of a Cumulative Bulletin, a ruling being "modified and superseded" is explained as describing "a situation where the substance of a previously published ruling is being changed in part and is being continued without change in part, and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self-contained. In this case, the previously published ruling is first modified and then, as modified, is superseded."[5] Whereas the first holding of Rev. Rul. 2007-54 is republished, the major modification of Rev. Rul. 2007-54 made by Rev. Rul. 2014-7 is the deletion of the second issue and holding, along with the entire analysis related to it. Thus, it appears that the IRS no longer takes the position that required interest for a federally prescribed reserve ("FPR") accounted for as part of the separate account should be calculated using the higher of the applicable federal interest rate of the prevailing state assumed interest rate. This would be consistent with the Industry Director Directive ("IDD")[6] that has been in effect since May 2010. By contrast, the IRS continues to take the position that all reserves for a variable contract, whether accounted for in the general account or the separate account, are taken into account under I.R.C. § 807(d). Having been so modified, Rev. Rul. 2007-54 is superseded by Rev. Rul. 2014-7. Rev. Rul. 2007-61 is obsoleted because the reason for suspending Rev. Rul. 2007-54—the second holding—no longer exists.

The second issue for consideration then is what exactly does Rev. Rul. 2014-7 stand for? As indicated above, Rev. Rul. 2014-7 republishes the first holding of Rev. Rul. 2007-54; it describes the same facts for Situation 1 and Situation 2, changing only the tax years referenced to more current years (2012 and 2013). Situation 1 considers a variable annuity contract that neither provides supplemental benefits nor involves qualified substandard risks. The facts indicate that for each year the FPR for the contract ($8,000 and $10,000, respectively) is greater than the net surrender value ($7,840 and $9,830) and less than the statutory reserve ($8,050 and $10,045). Situation 2 considers the same variable annuity contract except that the contract provides a minimum guaranteed death benefit ("MGDB"). The facts indicate that for each year the total of the general account and separate account FPRs for the contract with the MGDB is larger than in Situation 1 ($8,155 and $10,165), but that the FPR for the contract without the MGDB (i.e., the separate account FPR) would have been the same as

in Situation 1 ($8,000 and $10,000). Also, in Situation 2, for each year the net surrender value of the variable annuity contract is equal to the FPR amount for the contract without the MGDB ($8,000 and $10,000), and the total statutory reserves for each year are greater than the total FPR for the contract ($8,210 and $10,215). Just like the first holding of Rev. Rul. 2007-54, Rev. Rul. 2014-7 holds that, under I.R.C. § 807(d)(1), the amounts of the end-of-year life insurance reserves for the variable annuity contract in both Situation 1 and Situation 2 are the amounts of the tax reserve determined under I.R.C. § 807(d)(2) (i.e., $8,000 and $10,000 for 2012 and 2013, respectively, for Situation 1, and $8,155 and $10,165, respectively, for Situation 2).

The authorities cited and the analysis in Rev. Rul. 2014-7 are the same as those for the first holding in Rev. Rul. 2007-54 with one exception. The analysis in Rev. Rul. 2007-54 included a final sentence that Rev. Rul. 2014-7 omits. The sentence said: "The allocation of obligations between general account reserves and separate account reserves has no effect on the determination of the amount of IC's [the company's] life insurance reserves for Contract A under section 807(d)." Instead of including this sentence, Rev. Rul. 2014-7 concludes its analysis with a statement that the ruling provides guidance only with respect to the determination under I.R.C. § 807(d) of the amount of the life insurance reserves for a variable contract when some or all of the reserves are accounted for as part of a life insurance company's separate account reserves.

If one has an inclination to read more into the first holding of Rev. Rul. 2007-54, and also into its modified holding in Rev. Rul. 2014-7, one might wonder whether the ruling is aimed at answering the question of whether, for a variable contract, the comparison of the FPR to the net surrender value, and then to statutory reserves, is done based on the aggregate FPR for the contract or separately for FPR held in the general account and FPR held in the separate account. I have concluded that assuming Rev. Rul. 2014-7 is aimed at that question is reading too much into it. First, if that were the question to be answered by the ruling, the issue could have been stated a lot more clearly. Second, although the ruling cites both the comparison test of I.R.C. § 807(d)(1), which applies generally, and the separate accounting rules under I.R.C. § 817(c), which apply specifically for variable contracts, the analysis has no discussion of how these provisions might relate to each other. For example, the analysis does not say that the general rule that all FPR for a contract should be aggregated before compared to the net surrender value should override the separate accounting provision applicable specifically to variable contracts. Alternatively, the analysis does not explain that the specific separate accounting rule for income, exclusion, deduction, asset, reserve and other liability items that applies to variable contracts essentially requires that the separate account portions of a variable contract be treated as a contract that is issued as part of the separate account business, which under I.R.C. § 817 is accounted for as separate from the general account business. Third, the dollar amounts used in the facts do not allow the holding to illustrate clearly whether the I.R.C. § 807(d)(1) comparison should be done in the aggregate or separately for general and separate account reserves; it appears that the answer would be the same either way. Thus, the holding of Rev. Rul. 2014-7 merely illustrates that when the FPR is greater than the net surrender value, and less than the statutory reserves, the FPR amount is the life insurance reserve amount taken into account under I.R.C. § 807(d) (which is what I.R.C. § 807(d)(1) literally provides). ◂

END NOTES

1. 2014-9 I.R.B. 539 (Feb. 24, 2014).
2. 2007-2 C.B. 604.
3. For a discussion about how the company's share should be computed, see *Proration for Segregated Asset Accounts—How Is the Company's Share Computed?* 1 *Taxing Times*, Vol. 3, Issue 3 (September 2007); *Proration for Segregated Asset Accounts—Part Two*, 21 *Taxing Times*, Vol. 4, Issue 1 (February 2008).
4. 2007-2 C.B. 799.
5. In contrast, "revoked" describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling. It is my understanding that Rev. Rul. 2007-54 was not revoked because the IRS did not think the first holding was incorrect. Rev. Rul. 2007-54 was not revoked "in part" (i.e., the second holding) either.
6. On May 20, 2010, the IRS issued an IDD, LMSB-4-0510-015, which supersedes all prior directives regarding examining the DRD attributable to separate accounts of life insurance companies. The IDD affirms that Treas. Reg. § 1.801-8(e) sets forth a formula to be used in computing required interest at "another appropriate rate" for reserves accounted for as part of a separate account. It states that agents should consider raising the DRD issue if a life company's method for computing its company's share of investment income is inconsistent with I.R.C. § 812 and Treas. Reg. § 1.801-8(e), as illustrated by TAM 200038008 (Jun. 13, 2000) and TAM 200339049 (Aug. 20, 2002).

CONTINUED ON **PAGE 30**

DISTRICT COURT RULES § 4371 EXCISE TAX INAPPLICABLE ON FOREIGN-TO-FOREIGN RETROCESSIONS

By Edward C. Clabault

On Feb. 5, 2014, the U.S. District Court for the District of Columbia granted summary judgment for the plaintiff in *Validus Reinsurance Ltd. v. United States of America*, Civil Action No. 13-0109 (ABJ), and held as a matter of law that the Federal Excise Tax ("FET") on insurance transactions does not apply to retrocessions.

In this case, Validus Reinsurance Ltd. ("Validus Re"), a Bermuda reinsurer, had reinsured U.S. risks, and then retroceded a portion of those risks to foreign persons not eligible for an FET exemption under a Tax Treaty. The Internal Revenue Service (IRS), pursuant to its position as stated in Rev. Rul. 2008-15,[1] assessed an excise tax of 1 percent on Validus Re for the retrocession. Validus Re paid the tax, and appealed.

Under Internal Revenue Code ("IRC") § 4371, there is an excise tax of 4 percent that is imposed on each dollar of premium paid on (1) casualty insurance and indemnity bonds and an excise tax of 1 percent on (2) life insurance, sickness and accident policies and annuity contracts. There is also a 1 percent excise tax on reinsurance covering any contracts listed in (1) or (2).

In looking to the plain language of the statute, the Court found that the excise tax statute did not apply to retrocession transactions. The Court noted that the tax imposed on reinsurance transactions only applied to the reinsurance of contracts as defined under IRC § 4371(1) and (2), and would not apply to retrocessions because reinsurance is not listed in (1) or (2). The Court rejected the IRS' argument that retrocessions should be included under the excise tax statute to effect Congress' intent of placing U.S. and foreign reinsurers on equal ground (because foreign reinsurers are not subject to U.S. federal income tax). The Court noted that the language of the statute was clear and, therefore, did not look beyond it.

The Court's ruling in this case calls into question the interpretation of IRC § 4371 put forth by the IRS in Rev. Rul. 2008-15. Specifically, Situation 2 of that ruling contemplates a U.S. insurer that reinsures U.S. risks with Foreign Reinsurer A, which then reinsures those risks with Foreign Reinsurer B. Neither Foreign Reinsurer A nor Foreign Reinsurer B is eligible for an FET treaty exemption. The revenue ruling concludes that there would be an FET due on both reinsurance transactions. Given the Court's decision regarding retrocessions, the IRS' interpretation in this scenario may be in question, with the second of the two transactions being a retrocession not subject to the excise tax.

As part of its motion for summary judgment, Validus Re also raised the argument of whether the FET could apply to an extraterritorial transaction between foreign persons, arguing that the necessary congressional intent for extraterritorial application was not present. Finally, it articulated a constitutional argument, stating that as a matter of due process there must be a "substantial connection" between the United States and the transaction before Congress can tax it, claiming that there is no "substantial connection" in the foreign-to-foreign retrocessions at issue. In basing its decision solely on the plain language of the statute, the Court did not address these other arguments put forward by the plaintiff.

The decision leaves a few additional unanswered questions. For example, in Rev. Rul. 2008-15, Situation 1, a U.S. Corporation insures U.S. risks with Foreign Insurer, which then reinsures those risks with Foreign Reinsurer. Neither Foreign Insurer nor Foreign Reinsurer is eligible for an FET treaty exemption. The ruling concludes that the FET applies to both the direct insurance transaction between U.S. Corporation and Foreign Insurer, and the reinsurance transaction between Foreign Insurer and Foreign Reinsurer. Although the *Validus* decision addresses foreign-to-foreign retrocessions, the treatment of foreign-to-foreign reinsurance transactions similar to that discussed above remains unclear. Also unclear is the application of the excise tax to retrocessions from a U.S. reinsurer to a foreign person. Is this retrocession subject to tax at all? The *Validus* ruling appears to say that such a retrocession would not be subject to excise tax.

As this issue went to press, on April 3 the IRS filed a notice to appeal the *Validus* decision.◂

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END NOTES

[1] 2008-12 I.R.B. 633 (2008).

RENT-A-CENTER, INC. v. COMMISSIONER

By Edward C. Clabault

On Jan. 14, 2014, the Tax Court decided *Rent-A-Center, Inc. and Affiliated Subsidiaries v. Commissioner*, 142 T.C. No. 1 (2014) ("RAC Case" or the "Case"), involving a captive insurance arrangement that was challenged by the Internal Revenue Service (IRS). The Tax Court found that a parental agreement between a captive and its parent could be present in a valid insurance arrangement for federal income tax purposes. The Case also dealt with the manner in which risk distribution is measured in determining the existence of insurance. The taxpayer in the RAC Case was a Texas resident and the case was heard in Texas.

The taxpayer, Rent-A-Center, Inc. ("RAC"), was the parent group of approximately 15 affiliated subsidiaries. RAC, through stores owned and operated by its subsidiaries, rented, sold and delivered home electronics, furniture and appliances. Partly in response to high fees paid to a commercial insurer, RAC formed Legacy, a Bermuda Class I insurer, in 2002 in an effort to lower costs and improve efficiency. From 2003 through 2007, RAC obtained unbundled workers' compensation, automobile, and general liability insurance from Legacy up to a specified loss limit, and obtained coverage from Discover Re (an unrelated reinsurer) for losses in excess of those insured by Legacy.

RAC was a listed policyholder pursuant to the Legacy policies, but no premiums were attributable to RAC since it did not own stores, have employees or operate vehicles. Rather, RAC primarily operated through its subsidiaries, to which it would recharge premium expenses. Approximately 60 percent of the risk insured by Legacy was concentrated in one of RAC's 15 subsidiaries during the years at issue, and approximately 90 percent of the total risk was concentrated in four of its subsidiaries. Legacy received no premiums from unrelated entities from 2002 through 2007.

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As part of the Bermuda regulatory requirements, Legacy was required to maintain a specified level of capital. To increase its regulatory capital, Legacy petitioned its regulator for permission to treat its deferred tax assets as general business assets. In 2003, such permission was granted, with the stipulation that Legacy's parent guarantee its liabilities up to $25 million. While the guarantee included Legacy's liabilities under the Bermuda Insurance Act, it did not guarantee Legacy's general liabilities to unrelated insurers.

The test the Tax Court and the IRS have looked to in determining whether a captive qualifies as an insurance company for federal income tax purposes has three prongs, all of which need to be met: First, does the arrangement involve an insurance risk? Second, are adequate risk shifting and risk distribution present? Third, does the arrangement meet commonly accepted notions of insurance? Factors that have been considered in performing these analyses include whether the company is adequately capitalized and whether the captive company was formed for a valid nontax reason.

Noting that the IRS conceded that the policies issued by Legacy involved insurance risk, the Tax Court next examined whether the transaction met the risk shifting and risk distribution requirements. In determining that Legacy's policies shifted risk, the Tax Court focused on the arrangement's economic impact on RAC's subsidiaries, noting that the RAC subsidiaries' balance sheets would be unaffected in the event of an insured loss (which some commentators refer to as the "balance sheet test"). As highlighted in the dissent, an approach that assumes risk shifting can be present in brother-sister arrangements constitutes a departure from the Tax Court's prior position on this issue, as articulated in *Humana*.[1] Although its *Humana* position was reversed on appeal, this is the first time the Tax Court has acknowledged the existence of risk shifting in a brother-sister arrangement.

The Tax Court also found that the parental agreement between RAC and Legacy did not prevent the subsidiaries from

CONTINUED ON **PAGE 32**

shifting risk to the captive, noting that the parental guarantee did not affect the balance sheet test—the affiliates' balance sheets were protected whether or not the parental guarantee was in place. The Tax Court's decision in the RAC Case goes further than its decision in *Hospital Corp of America*, where the Tax Court found that the presence of a parental indemnity agreement that related to only a small portion of the captive's policies was not sufficient grounds to invalidate an otherwise bona fide insurance transaction.[2] In that case, the court disallowed the premium deduction based on a lack of risk shifting, but limited the disallowance to the portion of the coverage that was potentially subject to the parental indemnity agreement. The Tax Court distinguished several earlier cases that found that captive arrangements involving parental guarantees did not constitute insurance for federal income tax purposes.[3] In those cases, the captives were found to be undercapitalized and to have required guarantees at the behest of third-party insurers.

In finding that risk distribution was present, the Tax Court's analysis in the RAC Case focused on the number of risks at issue, not the number of legal entities taking part in the insurance arrangement. Further, in its risk distribution analysis, the Tax Court did not express concern with the concentration of risk in each entity (as noted above, one entity had over 60 percent of the total risk). As such, it did not find it necessary to rely on the safe harbor outlined in Rev. Rul. 2002-90, in which the IRS held that 12 subsidiaries, none with more than 15 percent of the total insured risks, were sufficient for finding risk distribution.[4]

The Tax Court's approach in the RAC Case stands in stark contrast to the IRS' position as described in Rev. Rul. 2005-40.[5] In concluding that risk distribution was not present, Rev. Rul. 2005-40 focused on the fact that one or two legal entities taking part in the arrangement—as opposed to the 12 subsidiaries under the Rev. Rul. 2002-90 safe harbor—were insufficient for risk distribution; in doing so, the revenue ruling ignored the presence of "a significant volume of independent, homogeneous risks."

The IRS has never articulated its rationale for determining risk distribution based on the number of insureds. That position, however, stands in contrast to general insurance principles, under which risk distribution, based on the law of large numbers, focuses on the number of independent risks rather than the number of insureds.

In reaching its conclusion that risk distribution was present in the RAC Case, the Tax Court noted that Legacy insured three types of risk: workers' compensation, automobile and general liability. Additionally, the Tax Court noted that during 2003 to 2007, RAC's subsidiaries owned between 2,623 and 3,081 stores, had between 14,300 and 19,740 employees, operated between 7,143 and 8,027 insured vehicles, and operated stores in all 50 states. The Tax Court made no mention of the number of legal entities insured as part of its analysis. The holding is significant because it provides further indication that the Tax Court views risk distribution based on general insurance principles, looking at the number of independent risks, rather than based on the IRS' "number of legal entities" approach, as outlined in Rev. Rul. 2002-90 and Rev. Rul. 2005-40. The RAC Case's rationale for risk distribution follows the approach found in *Gulf Oil*, where risk distribution was not dependent on the number of insured entities, and it was noted that "a single insured can have sufficient unrelated risks to achieve adequate risk distribution."[6]

The IRS has challenged numerous captive insurance arrangements involving one or a limited number of insureds—e.g., in cases involving protected cell companies and situations involving single member limited liability companies that are looked through for tax purposes—on risk distribution grounds. It is not clear whether the real concern of the IRS in those situations is actually one of risk transfer, and not risk distribution. While such a position would be rebuttable as well, a risk distribution analysis, which by definition is based on large numbers of independent risks, does not require that the number of legal entities insured be taken into consideration.

As of the time of this writing, the IRS had not indicated whether it will revisit its approach in Rev. Rul. 2002-90 and Rev. Rul. 2005-40, which focus on the number of insured entities, and focus instead on the number of independent risks in determining if a captive insurance arrangement has adequate risk distribution. The IRS has also not indicated whether the RAC Case could result in a different approach to parental guarantees and their role in invalidating captive insurance arrangements. The Case suggests that parental guarantees might not impact captive arrangements as long as the insured subsidiary's balance sheet is protected and the captive is adequately capitalized.

Also as of the time of this writing, the IRS had not indicated whether it would acquiesce to the Tax Court's decision. It is worth noting that this case was reviewed by all the judges from the Tax Court, with seven in favor of RAC, four concurring

in the result, and six dissenting. Any appeal would be heard by the 5th Circuit Court of Appeals. Assuming the facts cited are uncontested, to reverse the decision the Court of Appeals would need to find the Tax Court's legal determination "clearly erroneous." ◂

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END NOTES

1. *Humana Inc. & Subs. v. Commissioner*, 881 F.2d 247, 248 (6th Cir. 1989), *aff'g in part, rev'g in part and remanding* 88 T.C. 197 (1987).
2. See *Hospital Corp. of America v. Comm'r*, T.C. Memo 1997-482 (1997).
3. See *Malone & Hyde, v. Comm'r*, 62 F.3d 835 (6th Cir. 1995); *Carnation v Comm'r*, 71 T.C. 400 (1978); and *Kidde v. United States*, 40 Fed. Cl. 42 (1997).
4. 2002-52 I.R.B. 985 (Dec. 30, 2002).
5. 2005-24 I.R.B. 4 (July 5, 2005).
6. *Gulf Oil Corp. v. Comm'r*, 89 T.C. at 1010, 1026, (1987) (dictum), *rev'd in part on other grounds*, 914 F.2d 396 (3d Cir. 1990).

SUBCHAPTER L: CAN YOU BELIEVE IT? LIFE INSURANCE RESERVES NEED NOT ALWAYS BE "LIFE INSURANCE RESERVES"

By Peter H. Winslow

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The Internal Revenue Code (the "Code") permits life insurance companies to deduct on a reserve basis six categories of "items" listed in I.R.C. § 807(c). The first item is "life insurance reserves (as defined in section 816(b))." In general, I.R.C. § 816(b) limits the definition of "life insurance reserves" to amounts that are set aside on the annual statement for future unaccrued claims under life insurance, annuity, and noncancellable accident and health insurance contracts, and are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. Thus, on its face the Code could be read to condition the deduction for reserves with respect to the designated types of contracts on satisfaction of computational requirements for statutory reserves. As explained below, this is not what the cross-reference to I.R.C. § 816(b) in the list of deductible reserves really means. Instead, Congress intended that statutory reserves for future unaccrued claims under the types of contracts specified in I.R.C. § 816(b) should be deducted as life insurance reserves subject to I.R.C. § 807(d) whether or not they flunk the computational requirements for life insurance reserves in I.R.C. § 816(b).

This apparent inconsistency in the treatment of life insurance reserves is a result of the addition of I.R.C. § 807(d) in the Deficit Reduction Act of 1984 (the "1984 Act"). Under I.R.C. § 807(d), for purposes of determining the deduction or income from changes in tax reserves, "life insurance reserves" are required to be recomputed using the National Association of Insurance Commissioners (NAIC) prescribed method applicable for the type of contract and specified interest and mortality or morbidity assumptions. The drafters of I.R.C. § 807(d) understood that the cross-reference to the I.R.C. § 816(b) definition of life insurance reserves in the listing of deductible reserves created an ambiguity as to the treatment of non-qualifying statutory reserves. Can the company argue that the statutory reserves are deductible in full as another I.R.C. § 807(c) item and avoid the I.R.C. § 807(d) rules by intentionally establishing statutory reserves that do not satisfy the I.R.C. § 816(b) computational requirements? Can the Internal Revenue Service (IRS) argue in these circumstances that no reserve deduction at all is available? The legislative history to the 1984 Act answers these questions as follows:

> The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in present law required proper computation under State law in order for deductions to be allowed, because present

CONTINUED ON **PAGE 34**

> law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The bill, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves.[1]

This legislative history resolves the ambiguity in the statute created by the cross-reference to I.R.C. § 816(b) by clarifying that statutory reserves that could have been computed to qualify as life insurance reserves are required (not merely permitted) to be recomputed in accordance with I.R.C. § 807(d).

The backdrop of this clarification in the legislative history is the many disputes that arose under pre-1984 Act law on the consequences of failure of a reserve to qualify as a life insurance reserve. In prior law's three-phase system of tax, treatment of a reserve as a life insurance reserve could make a significant difference to so-called "Phase I companies" subject to tax on only their taxable investment income. The portion of net investment income considered added to life insurance reserves reduced the company's taxable investment income. Qualification as life insurance reserves was not determinative as to whether the reserves were deductible in gain from operations (Phase II). For this reason, IRS rulings dealing with life insurance reserves under pre-1984 Act law generally dealt solely with the life insurance reserve classification issue and not with the question of whether the non-qualifying reserves were deductible.

In audits, IRS agents who proposed to disallow reserves as life insurance reserves did not always disallow a deduction in Phase II gain from operations for the increase in reserves. And, if Exam did propose a deduction disallowance based solely on computational issues, Appeals Officers usually permitted the non-qualifying reserves to be deducted as unearned premium reserves (now classified as deductible reserves in I.R.C. § 807(c)(2)).

Several examples can illustrate the disputes that occurred under prior law that the 1984 Act legislative history sought to resolve. In Rev. Rul. 69-302,[2] the IRS ruled that gross unearned premium reserves for decreasing term credit life insurance policies computed using a sum-of-the-year-digits method did not qualify as life insurance reserves because they were not actuarially computed or estimated on the basis of recognized mortality tables and assumed rates of interest. The IRS' position was rejected in *Central National Life Insurance Co. of Omaha v. United States*,[3] because the court concluded that the gross unearned premium reserves were a reasonable estimate of tabular discounted reserves. This question of when a gross premium reserve was a proper estimate of a tabular discounted reserve was unresolved at the time the 1984 Act was being considered.

Congress resolved this issue in the 1984 Act, and the credit life reserve deduction dispute would not occur under current law. The gross unearned premium reserves would be recomputed under I.R.C. § 807(d) as the higher of net premium reserves using CRVM or the net surrender value, which in the case of credit life insurance would be the refundable portion of the gross premium in the event of termination of the policy.[4] Thus, the conclusion in Rev. Rul. 69-302 no longer is relevant for purposes of determining whether the reserve is deductible, and in what amount. It is notable that in this situation I.R.C. § 807(d), in effect, permits a deduction for gross unearned premium reserves as life insurance reserves if they qualify as net surrender values and exceed net premium CRVM reserves.

Although Congress decided to resolve the pre-1984 Act disputes as to the deductibility of reserves, it did not eliminate the disputes as they relate to the classification of the company as a life or nonlife insurance company. To be taxed as a life insurance company, more than 50 percent of the total statutory reserves still must be life insurance reserves that satisfy the I.R.C. § 816(b) definition (including the computational requirements) or unearned premiums and unpaid losses on noncancellable life, accident or health policies not included in life insurance reserves. The unexpressed, behind-the-scenes reason Congress did not clarify the definition of life insurance reserves for purposes of life company qualification was a desire to avoid causing companies to have their tax classification as a life or nonlife company shifted by reason of the adoption of the 1984 Act. It is evident that the IRS and Treasury sometimes wish that Congress had adopted a different approach and clarified that life insurance reserves do not need to satisfy the outdated computational requirements of I.R.C. § 816(b) to be included in the numerator under the 50 percent reserve ratio test. For example, if adopted, Proposed Treasury Regulations § 1.801-4(g) would override many pre-1984 Act IRS rulings and case law to provide that, if an insurance company does not compute or estimate statutory reserves using mortality or morbidity tables and assumed rates of interest, then either the taxpayer or the Commissioner may recompute the reserves to satisfy the requirements of I.R.C. § 816(b). Similarly, in Notice 2008-18, section 3.01,[5] the IRS stated that it may publish guidance to pre-

vent the adoption of principle-based reserves and what became Actuarial Guideline 43 from causing a company to be reclassified as a nonlife insurance company subject to tax under Part II of Subchapter L, instead of Part I applicable to life companies. These proposed regulations and notice further underscore that the computational requirements of I.R.C. § 816(b) should not be considered a prerequisite to a tax reserve deduction.

Let's take another example of an issue that arose under prior law. In a series of unpublished private rulings, the IRS adopted the position that substandard extra reserves on life insurance policies did not qualify as life insurance reserves unless they were actuarially computed. According to the IRS, a substandard extra reserve computed as a percentage of the extra gross premium charged the policyholder did not qualify, but an extra reserve computed by factors that grouped the substandard policies by age groups, policy duration, and plan of insurance, and used ratios that approximated the greater mortality by rating class did qualify. Under current law, it does not matter whether the substandard extra statutory reserves qualify as life insurance reserves. Under I.R.C. § 807(d)(5), the reserves are required to be calculated using the specified standard mortality table "adjusted as appropriate" for the non-standard risks. The deduction issues under current law are limited to whether the risks are non-standard and, if so, what adjustment to the standard table is appropriate.

Another example helps illustrate how the statute works. Under pre-1984 Act law, many disputes arose as to whether disability disabled-lives reserves qualified as life insurance reserves. One type of disability disabled-lives reserves arose under group life insurance policies as a waiver-of-premium benefit in the event of an insured's disablement. Many companies held disability waiver-of-premium reserves using a rule-of-thumb equal to 75 percent of the face amount of insurance in force. This again raised the issue as to whether reserves were properly estimated. In *Group Life & Health Insurance Co. v. United States*,[6] a district court held that these reserves qualified as life insurance reserves because they were based on a Society of Actuaries (SOA) study that considered mortality and interest rates. On appeal, the Fifth Circuit reversed, finding that the company itself had not made its own actuarial estimates in adopting the SOA's rule-of-thumb reserve method. Under current law, this dispute would be relevant only for life insurance company qualification under I.R.C. § 816(b), not for reserve deduction purposes. As reserves for supplemental benefits under I.R.C. § 807(e)(3), the statutory reserves would be deductible in full whether or not they are considered to be computed or estimated using recognized mortality or morbidity tables and assumed rates of interest under I.R.C. § 816(b).

The legislative history explaining how the statute was intended to work has important implications as to the deductibility of reserves in the event the NAIC-adopted principle-based reserves standard becomes operative. Two observations are critical. First, Congress intended the I.R.C. § 807(d) tax reserve computation rules to apply to all reserves held for future unaccrued claims under life insurance, annuity, and noncancellable accident and health insurance contracts regardless of how statutory reserves are computed. Second, in adopting I.R.C. § 807(d), Congress did not have a conceptual problem with allowing a deduction for at least some types of reserves that are computed in a way that fails to satisfy the technical requirements of I.R.C. § 816(b). For example, Congress understood that gross unearned premium reserves and statutory rule-of-thumb reserves for supplemental benefits would be deductible as life insurance reserves under I.R.C. § 807(d) regardless of the cross-reference to I.R.C. § 816(b).

What this means, to this commentator at least, is that, if the NAIC prescribes new methods of computing minimum reserves that become operative, I.R.C. § 807(d)'s deference to the NAIC method for tax reserves would require that method to be used for deduction purposes for newly issued contracts regardless of whether the resulting reserves would be considered to qualify as life insurance reserves under I.R.C. § 816(b).[7] In other words, under Subchapter L, as amended by the 1984 Act, it may not matter for deduction purposes whether life insurance reserves are life insurance reserves. ◂

END NOTES

1. S. Rep. No. 98-169, pt. 1 at 539-40 (1984); H.R. Rep. No. 98-432, pt. 2 at 1414 (1983).
2. 1969-1 C.B. 186.
3. 574 F.2d 1067 (Ct. Cl. 1978).
4. In contrast to I.R.C. § 807(d), for purposes of the cash value accumulation test in I.R.C. § 7702(b) for qualification as a life insurance contract, the refundable portion of the gross unearned premium of a credit life insurance policy is not included in the cash surrender value because it is not subject to policy loan borrowing. S. Rep. No. 98-169, pt. 1 at 573 (1984).
5. I.R.B. 2008-5 (Jan. 14, 2008).
6. 42 AFTR 2d 78-6282 (N.D. Tx. 1978), rev'd 660 F.2d 1042 (5th Cir. 1981).
7. *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir. 2012).