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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 deduct-

ible 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.