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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

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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RFI invited comments by April 29, 2011, about which Treasury regulations should be modified, expanded, streamlined or repealed in order to make the Department's regulations more effective, less burdensome or both.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commenters to respond to a series of questions, including the following question: "Are there Treasury rules that are outdated or contrary to recently enacted statutes, or otherwise in need of updating?"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.