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PARTIAL EXCHANGE GUIDANCE KEEPS IMPROVING

*By Bryan W. Keene and John T. Adney**

On June 28, 2011, the Internal Revenue Service (the "Service") issued Rev. Proc. 2011-38,[1] which provides guidance on the tax treatment of a partial exchange of a non-qualified deferred annuity contract for another annuity contract.[2] The new revenue procedure is the latest—and best—in a series of pronouncements in which the Service has attempted to walk the line between allowing legitimate partial exchanges of deferred annuities to occur while discouraging those perceived as abusive.[3] To that end, Rev. Proc. 2011-38 borrows concepts that worked well from earlier rulings and jettisons those that created confusion and complexity.

In particular, it eliminates the approach in Rev. Proc. 2008-24 of automatically and retroactively treating certain partial exchanges as tax-avoidance devices. Instead, the new guidance restores and improves upon the approach in Notice 2003-51 of identifying certain partial exchanges that the Service will scrutinize more closely using general tax principles. The new guidance also shortens (from 12 to six months) the window following a partial exchange in which the transaction could be called into question, and simplifies the regime by de-linking it from the exceptions to the section 72(q) penalty tax.[4] Finally, the guidance provides coordination with recent partial annuitization legislation and answers to other open issues. The result is the clearest and most workable pronouncement to date on the tax treatment of partial exchanges.

This article begins with an overview of how the tax treatment of partial exchanges has evolved over the last decade or so, including the concerns that led the Service to resist giving taxpayers *carte blanche* on such transactions. The article then summarizes Rev. Proc. 2011-38 and elaborates on why the features outlined above are important and helpful improvements over prior guidance.

CONTINUED ON PAGE 6

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FROM THE EDITOR
IN THIS ISSUE

By Christian DesRochers

To say this has been an unusual fall would be an understatement. I happened to be in Washington, D.C. for the earthquake. And here in Connecticut, thanks to Hurricane Irene and Winter Storm Alfred, our normally quiet neighborhood has featured the sounds of chainsaws and generators running. As I write this, I have snow on the ground in my yard, which is expected in February, but not in late October. For some, a hot shower is a luxury, which makes us appreciate the little things in life when we don't have them.

Getting back to the business of life insurance taxation and *Taxing Times*, this issue addresses a variety of topics, including a discussion by Ed Robbins and Stephen Baker related to the treatment of federal income tax in actuarial projections, as well as articles and tidbits on recent guidance. These cover topics ranging from Notice 2011-53 addressing FATCA (the Foreign Account Tax Compliance Act), the economic substance doctrine, the necessary premium test under section 7702A and SEPP guidance on annuities.

As we look to the future, the Obama administration has proposed changes related to life insurance companies and products as a part of the 2012 budget. These include:

1. ***Modify the reporting requirements for life settlement contracts***—The proposal would expand information reporting on the sale of life insurance contracts and the payment of death benefits on contracts that were sold, and would modify the "transfer-for-value" exceptions to prevent purchasers of policies from avoiding tax on death benefits that are received. It would apply to sales or assignment of interests in life insurance policies and payments of death benefits for taxable years beginning after Dec. 31, 2011.

2. ***Modify the dividends received deduction (DRD)—***The separate account DRD has been the subject of much controversy between the Internal Revenue Service (IRS) and the industry. Under the administration proposal, the DRD with regard to separate account dividends would be based on the proportion of reserves to total assets of the account. The administration has also proposed a change in the general account DRD. Under the proposal, the DRD with regard to general account dividends would be subject to the same flat proration percentage that applies to non-life companies under current law (15 percent). In their "Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal," the Joint Committee on Taxation discussed an alternate approach that would base the general account DRD on a percentage determined by the ratio of the tax-exempt assets to total assets. (See JCS-3-11 June 2011, 286.) The proposal would be effective for taxable years beginning after Dec. 31, 2011. *(Editor's Note: In their discussion of the separate account DRD, the Joint Committee staff cited Susan Hotine's Taxing Times articles related to the issue.)*

3. ***Expand the pro-rata interest expense disallowance for corporate-owned life insurance***—The interest deductions of a business other than an insurance company are reduced to the extent the interest is allocable to unborrowed policy cash values on life insurance and annuity contracts. Under the proposal, the exception for officers, directors and employees would be repealed unless those individuals are also 20 percent owners of

the business that is the owner or beneficiary of the contracts. The proposal would apply to contracts issued after Dec. 31, 2011, in taxable years ending after that date.

4. ***Require information reporting for private separate accounts of life insurance companies***—The proposal would require information reporting with regard to each life insurance or annuity contract whose investment in a separate account represents at least 10 percent of the value of the account. The proposal would be effective for taxable years beginning after Dec. 31, 2011.

Given the current political debate in Washington, it is far from clear that any of the proposals will be enacted.

With respect to the IRS, the Year-End 2010-2011 Priority Guidance Plan included a number of issues related to the life insurance industry. Two issues that remain under consideration include:

1. Guidance clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6) (the "statutory cap").

2. Guidance under §7702 defining cash surrender value.

The Plan also includes guidance on the separate account DRD issue. As noted above, the issue is included in the administration budget, so the expectation is that it will be handled by legislation rather than guidance.

As always, our authors will provide commentary on these and other issues as they arise. The process of putting *Taxing Times* together is truly a team effort, including the editorial board, the authors, the reviewers, editorial staff and the Society of Actuaries' staff. Together, it always seems to come together, which is a tribute to the entire team. Once again, I'd like to thank everyone who worked on this issue.

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FROM THE CHAIR
GUESS WHAT?

By Kristin Schaefer

My 5-year-old grandson's favorite phrase is "Guess what?!" And he always sounds so excited when he says it. Like he has the best secret in the world, and he just can't wait to share it with you. Well, guess what? I'm excited to be the incoming chair of the Taxation Section Council and can't wait to share some of our plans for this year!

Before I get to this year's plans, I'd like to summarize our accomplishments from last year. The Tax Reserves Seminar in Orlando last spring was informative and well-attended. The "What is CARVM?" webinar last summer helped provide guidance on tax reserves for in-force variable annuity guaranteed living benefits. The various sessions sponsored by the Taxation Section at the Life and Annuity Symposium, Health Meeting, Valuation Actuary Symposium and Annual Meeting were instrumental in bringing attendees up-to-date on the most current tax issues. And last, but not least, the Necessary Premium Test (NPT) Task Force that was organized in the fall of 2010 made major strides last year. The task force collected survey data from 21 companies and presented the results at the section breakfast during the 2011 Annual Meeting in Chicago.

I'd like to thank the outgoing council members, Brian Prast, Jo Finley, and especially the outgoing chair, Steve Chamberlin, for helping to make last year a success. I'd also like to thank the many friends of the council who continued to volunteer to speak at meeting sessions, lead the NPT Task Force, and put together our illustrious newsletter, *Taxing Times*.

I'd also like to welcome our incoming council members, Stephanie Burmester, Brenna Gardino and Samantha Knackmuhs. It's always exciting to have new people join the group and bring in fresh talent and ideas.

Now for this year's plans. Many of our plans for this year build on activities of the past. The NPT Task Force is continuing its work on researching the requirements and administration of the necessary premium test. We plan to have another one or two webinars relating to guidance from the Internal Revenue Service that is expected to be published this year. We will continue to offer timely and educational sessions at the various Society of Actuaries meetings. One of our biggest projects will be the Product Tax Seminar that we plan to have this fall, so stay tuned for more information on that. And of course we will continue to produce one of the most-praised section newsletters of the Society of Actuaries.

Of course none of these projects would be possible without the help of many volunteers. While we are fortunate to have an active council and many active friends of the council, we are always looking for new people to get involved. So if you are interested in helping with any of the activities I've mentioned; have an idea for a session topic, webinar, research project or newsletter article; would like to run for section council; or just want to talk to someone who's as excited about tax as you are, please feel free to contact me or any other council member.

Looking forward to a great year!

Kristin A.L. Schaefer, FSA, MAAA, is an actuary with Transamerica Corporate Actuarial and may be reached at *kristin.schaefer@transamerica.com.*

Mark your calendar and plan to attend the 2012 Health Meeting. We're heading to the Big Easy—and planning more topical sessions to provide you with the latest updates on important health issues. Expect top-notch speakers and numerous of networking events—and the opportunity to earn lots of CPD credit. There'll be plenty to see and do in New Orleans while you're there: Chill out in a blues or jazz club; check out the city's well-known architecture; take a riverboat tour or carriage ride; or—head to the outskirts to see sprawling plantations and the incredible wildlife.

Here's what last year's attendees had to say:

"Thought provoking and extremely worthwhile." **"Gained great industry insight!"**

"Excellent content and thoughtful delivery." **"Ample opportunities to earn professionalism credit."**

"Sessions were great! Loved the smaller groups and wide range of topics!"

http://HealthSpringMeeting.soa.org.

BACKGROUND

1. The Basic Transaction and the Service's Concerns

The question of how partial exchanges of non-qualified annuities should be treated for tax purposes involves the interaction of sections 72 and 1035. Under section 72(e), a withdrawal from a deferred annuity is taxable using an "income-first" ordering rule, meaning that all income on the contract must be distributed before any investment in the contract can be recovered. The income thus received is taxed at ordinary rates, and a 10 percent penalty tax applies under section 72(q) unless an exception is available.

Section 1035 provides nonrecognition treatment for "an exchange of an annuity contract for an annuity contract." In other words, the exchange does not trigger tax on any gain in the contract. Rather, such tax is triggered only when a withdrawal or other distribution subsequently occurs under the contract. If an exchange would qualify for nonrecognition treatment under section 1035 but for the fact that the property received in the exchange consists not only of property described in that section but also of other property or money (commonly called "boot"), then gain will be recognized to the extent of the boot.[5]

In most exchanges of a deferred annuity, a contract's entire cash value is transferred to another annuity contract, and the original contract terminates. In a *partial* exchange, only some (not all) of the cash value is transferred, and the original contract remains in force with the remainder of the cash value. As recounted in prior issues of *Taxing Times*,[6] the hubbub about partial exchanges arose because the Service was concerned that taxpayers might use the treatment of such exchanges under section 1035 to circumvent section 72. This potential can be illustrated by a simple example.

Assume that a deferred annuity has a $200 cash value, which is comprised of an $80 investment in the contract and a $120 tax-deferred gain. The owner needs $100 in cash. If he or she takes a $100 withdrawal from the contract, it will be taxable in full and a $10 penalty tax may apply. Instead, the owner decides to partially exchange half of the contract for a new one, resulting in two contracts with a $100 cash value and $60 tax-deferred gain each. The owner then surrenders one of the contracts for $100, with only $60 being taxable and a maximum penalty tax of $6.[7] Obviously, the Service had a strong interest in discouraging the use of partial exchanges as a planning tool to achieve these types of results.

2. Conway v. Commissioner

In *Conway*, the Service disallowed nonrecognition treatment under section 1035 for a partial exchange upon an audit of Ms. Dona Conway for the 1994 tax year.[8] Ms. Conway appealed the Service's disallowance and represented herself in the Tax Court. The Service argued that section 1035 does not apply to an exchange of annuity contracts unless the entire original contract is replaced by a new contract. The Tax Court disagreed and held that section 1035 applied. In so holding, the court observed that nothing in the statute or regulations conditions nonrecognition treatment on the entire contract being exchanged, either expressly or by any necessary implication, and that Ms. Conway's partial exchange was consistent with the legislative intent of section 1035.[9]

The Service acquiesced to the *Conway* decision in 1999, but not without including a caveat hinting at the nature of future guidance on partial exchanges.[10] In particular, the Service said it would follow *Conway* as long as the funds in the original contract remained invested in annuity contracts after and during the transaction, but that it would continue to challenge partial exchanges that are entered into as part of a design to avoid the section 72(q) penalty tax or other limitations imposed by section 72. In such cases, the Service indicated that it "will rely upon all available legal remedies to treat the original and new annuity contracts as one contract."

3. Notice 2003-51: The Rebuttable Presumption and Subjective Intent

Following the *Conway* decision and the Service's acquiescence, questions remained about which partial exchanges the Service would respect and which it might attack as tax avoidance devices. For example, when would a partial exchange be "old and cold" enough that a subsequent withdrawal would not risk the Service disputing the transaction's treatment under sections 72 and 1035? The Service responded to these and other questions in Notice 2003-51.[11]

The Notice announced that the Service was considering publishing regulations addressing the question of when a partial exchange followed by a withdrawal or surrender should be presumed to have been entered into for tax avoidance purposes. Under the contemplated regulations, this negative presumption would be triggered by any surrender or distribution occurring within 24 months of a partial exchange. Taxpayers could rebut the presumption "by demonstrating that the surrender or withdrawal was not contemplated at the time the partial exchange was completed." For this purpose, the Notice said that the Service was considering whether to treat any surrender or distribution that is not subject to the section 72(q) penalty tax as successfully rebutting any presumption of a tax avoidance intent, and whether to provide additional exceptions tied to certain life events (divorce, job loss, *etc*.).

Pending the issuance of any regulations, Notice 2003-51 provided interim guidance on when the Service would respect a partial exchange and when it might view the transaction as a tax-avoidance device. Consistently with the regulations the Service was considering, the guidance established a safe harbor under which the Service would not challenge the treatment of a partial exchange as long as the taxpayer did not surrender or take a withdrawal from either contract within 24 months after the exchange. This effectively set the "old and cold" standard at two years.

If a withdrawal or surrender occurred during the 24-month window, the Service would consider all the facts and circumstances and apply general principles of tax law (presumably the step transaction or economic substance doctrine) to determine whether the partial exchange and subsequent distribution should be recast as an "integrated transaction." In that case, the two contracts would be viewed as a single contract for purposes of determining the tax treatment of the distribution under section 72(e).

Notice 2003-51 also provided that taxpayers could avoid elevated scrutiny of partial exchanges that were followed by distributions within the ensuing 24 months if the transaction met a two-part test. In particular, such transactions would be respected if the taxpayer could demonstrate that (a) one of the conditions of section 72(q)(2) (providing exceptions to the section 72(q) penalty tax), or any similar life event, such as a divorce or job loss, "occurred between" the partial exchange and the surrender or distribution, *and* (b) the surrender or distribution was not contemplated at the time of the partial exchange. Thus, the first prong of the test was an objective standard based on the exceptions to the section 72(q) penalty tax or similar life events, and the second prong was a subjective standard based on the taxpayer's actual intent.

While Notice 2003-51 helped clarify how the Service intended to treat partial exchanges, several questions remained unanswered and the Notice received some criticism.

The implication of this two-part test was that the safe harbor was not available unless an exception to the section 72(q) penalty tax (or something similar) also applied, even if the taxpayer lacked any actual intent to use the transaction as a tax avoidance device. Likewise, the safe harbor was not available if the taxpayer entered into the transaction to avoid tax, even if an exception to the section 72(q) penalty tax (or similar exception) was available. Of course, the loss of the safe harbor for any reason meant only that the Service might scrutinize the transaction more closely and apply general tax principles to determine whether it should be recharacterized for tax purposes. In other words, unlike subsequent guidance (discussed below), Notice 2003-51 did not establish a bright line rule under which transactions falling outside its scope would be automatically and retroactively recharacterized for tax purposes.

While Notice 2003-51 helped clarify how the Service intended to treat partial exchanges, several questions remained unanswered and the Notice received some criticism. Many thought the 24-month period was too long and that transac-

CONTINUED ON **PAGE 8**

tions should be deemed old and cold long before then. Others observed that the subjective prong of the two-part test described above was impossible for life insurers to administer in accordance with their tax reporting obligations because they would almost never know their customers' true intentions. Still others raised questions about how the Service would treat a "failed" partial exchange, *e.g.*, whether the partial exchange would be ignored so that the old and new contract would continue to be treated as one integrated contract, or whether the partial exchange would be recharacterized as a taxable withdrawal followed by the purchase of a second contract with after-tax monies. In light of these and other questions, the guidance was extremely difficult for insurers and individual taxpayers to administer.

4. Rev. Proc. 2008-24: A Harsher Presumption but Broader Safe Harbor

In 2008, the Service attempted to address some of the criticisms of the 2003 guidance by publishing Rev. Proc. 2008-24.[12] Perhaps most significantly, it clarified how the Service would treat a partial exchange followed by a withdrawal or surrender that did not meet the requirements of the available safe harbor. Under the earlier 2003 guidance, such a transaction simply might trigger elevated scrutiny by the Service, with the possibility (but not certainty) that the Service would apply general principles of tax law to recharacterize the transaction in light of all the facts and circumstances.

Rev. Proc. 2008-24 provided a harsher, albeit clearer, result. It established a conclusive presumption that any partial exchange followed by a withdrawal or surrender that did not meet the available safe harbor was effectively an abusive tax avoidance device. Rev. Proc. 2008-24 said that the Service would recharacterize any such transaction as a taxable withdrawal from the source contract followed by the payment of an after-tax premium for the second contract. Taxpayers were not afforded an opportunity to rebut this presumption, making it all the more important to fall within the safe harbor provided by Rev. Proc. 2008-24.

In that regard, Rev. Proc. 2008-24 generally retained the same standards as the safe harbor in Notice 2003-51, but modified them in several ways to make them easier to meet. First, it shortened (from 24 to 12 months) the window following a partial exchange in which a withdrawal or surrender could cause a loss of the safe harbor. Second, it eliminated the subjective intent prong of the two-part test for determining whether a withdrawal or surrender during the 12-month window would make the safe harbor unavailable. This change, in particular, was met with applause because it removed insurers from the mind-reading business.

In light of these and other changes, the new standard under Rev. Proc. 2008-24 can be summarized as follows. Partial exchanges would be respected if there were no withdrawal or surrender from either contract within 12 months of the exchange. If there were a withdrawal or surrender in that window, the transaction would still be respected if an objective test was met. That test would be met if certain events or conditions enumerated in the list of statutory exceptions to the section 72(q) penalty tax (or any similar life event) "occurred between" the date of the partial exchange and the distribution. The test could not be met, however, by relying on the exceptions to the penalty tax for "substantially equal periodic payments" or "immediate annuities,"[13] because the Service was separately considering guidance on partial annuitizations and wanted to keep its powder dry on those issues. If a withdrawal or surrender occurred within the 12-month window and did not meet the foregoing test, the Service would recharacterize the transaction as described above.[14]

This latter point—the consequences of falling outside the safe harbor—drew considerable criticism from the life insurance industry. In particular, insurers expressed concern that the new regime imposed rules that were extremely difficult or impossible to administer from a tax reporting perspective. The difficulty related primarily to the retroactive nature of the recharacterization of a prior partial exchange as a taxable withdrawal. Such retroactivity raised questions about the need to file amended information returns. It also would affect the investment in the contract and income on the contract records for both contracts involved in the transaction, which would lead to ongoing reporting problems for future distributions if the records were not adjusted to reflect the exchange transaction's recharacterized nature. Making matters worse, insurers might not even have the information needed to properly adjust their records or tax report. For example, they might not know that an incoming exchange was a *partial* exchange for which they needed to monitor compliance with the 12-month rule, or they might not know that a withdrawal from another carrier's contract resulted in a recharacterization of a prior partial exchange involving their own contract. These and other potential reporting difficulties caused much confusion and dissatisfaction with the 2008 guidance.

Another significant question that arose under Rev. Proc. 2008-24 was how to interpret the requirement that certain events must "occur between" the date of a partial exchange and a withdrawal or surrender in order for the safe harbor to apply to transactions that failed the 12-month rule. This question was not necessarily new, as Notice 2003-51 used the same "occurred between" language in the objective prong of its two-part test. The language received more attention, however, under Rev. Proc. 2008-24. This renewed focus may have been attributable to the fact that the new guidance eliminated the subjective intent component of the safe harbor and clarified the consequences of falling outside the safe harbor, making it more important for insurers to ensure that they were properly interpreting the objective standard so they could meet their tax reporting and withholding obligations.

The problem that many observed with the language was that some of the penalty tax exceptions cannot literally "occur between" a partial exchange and a subsequent distribution.[15] This suggested that the Service could not have intended "occurred between" to be interpreted literally, since doing so would render parts of the guidance meaningless. On the other hand, the revenue procedure said what it said, which was "occurred between." Also, the fact that the Service was concerned with taxpayers intentionally using partial exchanges followed by withdrawals to avoid tax under sections 72(e) and (q) suggested that the Service might interpret the language literally. If an event occurred after a partial exchange and changed the taxpayer's circumstances, then a withdrawal taken after that event (and within the 12-month window) might be attributable to the taxpayer's changed circumstances, rather than an original intent to avoid tax. In other words, a literal interpretation of the "occurred between" language arguably instituted an objective way of gauging the taxpayer's intent, which had been at the heart of the Service's concerns with partial exchanges since at least Notice 2003-51.

Not surprisingly then, the Service's initial response to informal inquiries about the intended scope of the "occurred between" language was that it should be read literally, a view that some representatives of the Service repeated during public speaking engagements. The life insurance industry and its representatives argued for a broader interpretation, noting various anomalies and irrational results that might ensue from the literal view the Service suggested. The most discussed of these potential results involved the exception to the penalty tax for distributions made on or after the date an individual attains age 59½. The industry argued that it would be irrational to allow a person who happens to turn age 59½ within 12 months of a partial exchange to take a withdrawal or surrender without adverse tax consequences, but not to allow a person who was already that age to do so. The Service ultimately softened its initial interpretation on this point, as discussed in more detail below.

5. The Great Age 59½ Debate

Based on a plain reading of the "occurred between" language in Rev. Proc. 2008-24 and the Service's initial remarks about the intended scope of that language, many insurers began telling their policyholders that they would interpret the language literally for tax reporting purposes. Meanwhile, the Service appeared to be telling individual taxpayers something different.

In 2010, at least one individual taxpayer approached the Wage and Investment Division of the Service to ask whether a partial exchange occurring after age of 59½ would be recharacterized by Rev. Proc. 2008-24 if the taxpayer took a withdrawal within the ensuing 12 months. The Wage and Investment Division responded with a letter saying that "[a]s the individual was age 68 at the time of the original exchange, obviously he would qualify for the exception of being over the age of 59 and a half and would thus not be treated as doing this exchange for tax avoidance purposes." While this was "obvious" to the Wage and Investment Decision, it was news to the insurance industry, which had only the literal language of Rev. Proc. 2008-24 to rely upon, as colored by the initial, informal statements from the government suggesting a literal intent. The industry pointed out the inconsistent messages to the Insurance Branch at the Service's National Office and urged the prompt issuance of clarifying guidance.

The problem that many observed with the language was that some of the penalty tax exceptions cannot literally "occur between" a partial exchange and a subsequent distribution.

Later in 2010, the Service issued PLR 201038012,[16] which confirmed the view expressed in the Wage and Investment Division letter. The Service reasoned that the exceptions to the 12-month rule in Rev. Proc. 2008-24 incorporate the age 59½ exception of section 72(q)(2)(A) by reference, and that the standard imposed by that section is whether a distribution has occurred "on or after" the date the taxpayer turns age 59½. The ruling concluded that because the withdrawal occurred after the date the taxpayer reached age 59½, the exception to the 12-month rule applied and the Rev. Proc. 2008-24 safe harbor was met.

CONTINUED ON **PAGE 10**

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Although private letter rulings cannot be cited as precedent,[17] the necessary implication of PLR 201038012 was that any taxpayer who was at least age 59½ could partially exchange a deferred annuity for a new one, immediately surrender either contract, and recover the allocable investment in the contract tax-free. This interpretation arguably protected the Service against taxpayers using partial exchanges followed by withdrawals to circumvent the section 72(q) penalty tax to the extent that it required them to independently meet an exception to the penalty tax at the time of the withdrawal. However, the interpretation appeared to provide the Service with no protection against the other concern it had expressed with partial exchanges, namely, circumvention of the income-first ordering rules of section 72(e). And the fact that about 72 percent of owners of non-qualified deferred annuities are over the age of 64 suggested that many would have at least the opportunity to achieve such results.[18]

Despite this potential risk to the Service, its interpretation of the "occurred between" language was the most reasonable one to make under the circumstances, particularly in light of the consequences that Rev. Proc. 2008-24 assigned to a transaction falling outside its safe harbor. The lack of protection that the interpretation provided against gaming the section 72(e) rules was perhaps more indicative of a flaw in an approach that relied almost exclusively on the exceptions to the section 72(q) penalty tax to provide such protection within the 12-month waiting period. After all, section 72(e) continues to apply even after a taxpayer attains age 59½, so that particular exception is not necessarily the perfect candidate to enforce the intent of section 72(e), if that is what the Service was trying to accomplish. As discussed next, the Service ultimately revamped its approach to eliminate this reliance on the penalty tax exceptions, which did much to rationalize and simplify the entire regime.

REV. PROC. 2011-38

The Service's revamped approach to partial exchanges was published as Rev. Proc. 2011-38 in June of 2011. The new approach incorporates and improves upon aspects of the 2003 and 2008 guidance that worked well and eliminates other aspects that caused confusion and complexity.

Under the new approach, partial exchanges will be respected if there is no withdrawal or surrender from either contract within 180 days of the exchange. Thus, Rev. Proc. 2011-38 shortens the "old and cold" window from 12 to six months. If there is a withdrawal or surrender in this shortened window, the Service will apply general tax principles to determine the substance, and hence the treatment, of the entire transaction. In applying such principles, the Service may recharacterize the transaction as, for example, taxable "boot" that is received in a tax-free exchange or a taxable distribution under section 72(e). This approach is reminiscent of Notice 2003-51, in that transactions falling outside the safe harbor will merely trigger the possibility of elevated scrutiny from the Service, rather than automatic recharacterization as under Rev. Proc. 2008-24.

The new revenue procedure also modifies the safe harbor by eliminating the prior exceptions for withdrawals and surrenders during the post-exchange waiting period. In other words, a partial exchange followed by a withdrawal or surrender within six months could be subject to elevated scrutiny, even if the taxpayer lacks subjective intent to use the transaction as a tax avoidance device and even if an exception to the section 72(q) penalty tax applies to the withdrawal or surrender. As a result, the "occurred between" language in Rev. Proc. 2008-24 that led to much confusion has been eliminated. Likewise, the age 59½ exception to the penalty tax is no longer relevant to the partial exchange analysis.

This latter point could be interpreted as a narrowing of the safe harbor under Rev. Proc. 2008-24, in that the Service had privately interpreted that safe harbor in a way that made it available to anyone over age 59½ (which is most annuity owners), irrespective of the timing of any subsequent withdrawal or surrender. However, the softening of the consequences of falling outside the safe harbor would seem to counterbalance any perceived narrowing of its scope, and de-linking the safe harbor from the penalty tax exceptions arguably simplifies and rationalizes the Service's approach to addressing its concerns with partial exchanges. Moreover, the new approach would seem to eliminate the tax reporting issues that arose under the prior guidance, since the implication of Rev. Proc. 2011-38 is that a partial exchange will be respected in the absence of an affirmative action by the Service to recharacterize it. In other words, insurers generally are no longer responsible for policing which partial exchanges should be disallowed; that burden has been shifted back to the Service to bear on a case-by-case basis. As a result, insurers should be able to apply the same reporting procedures to partial exchanges as they do to full exchanges.

Finally, Rev. Proc. 2011-38 makes two additional helpful clarifications. First, it coordinates the partial exchange rules with the new statutory rules governing partial annuitizations. In 2010, Congress passed legislation allowing partial annuitizations under non-qualified annuities, as long as the payments are life-contingent or scheduled for at least 10 years.[19] Rev. Proc. 2011-38 acknowledges this development by extending its safe harbor to partial exchanges that are followed by distributions in the form of annuity payments, irrespective of when those payments commence, as long as they conform to the partial annuitization legislation. Second, Rev. Proc. 2011-38 clarifies that a partial exchange that occurs within 180 days of another partial exchange is not treated as a withdrawal or surrender for purposes of applying the 180-day requirement. This effectively facilitates a series of partial exchanges without triggering the potential for elevated scrutiny by the Service.

Rev. Proc. 2011-38 is effective for partial exchanges that are completed on or after Oct. 24, 2011. The prior guidance in Rev. Proc. 2008-24 continued to apply to partial exchanges that were completed before that date, with the clarification that the "occurred between" requirement for the safe harbor applicable to withdrawals and surrenders within 12 months of a partial exchange was treated as satisfied if the taxpayer was age 59½ (or met one of the other listed conditions) as of the date of the withdrawal or surrender. Thus, for the interim period before the new guidance became effective, the Service confirmed in published guidance the interpretation it previously adopted in PLR 201038012.

CONCLUSION

Rev. Proc. 2011-38 borrows and improves upon the concepts that worked well from earlier rulings on partial exchanges and jettisons the concepts from those rulings that created confusion and complexity. In doing so, Rev. Proc. 2011-38 provides the clearest and most workable pronouncement to date on the tax treatment of partial exchanges. The latest approach balances the government's interest in curbing perceived abuse while allowing legitimate partial exchanges to occur under a regime that life insurers, policyholders and the Service can easily administer. ◂

END NOTES

* The authors would like to thank Adam Harden, an associate with Davis & Harman LLP, for his contributions to this article.

1 2011-30 I.R.B. 66.

2 The partial exchanges discussed in this article are limited to those involving non-qualified deferred annuities. The tax treatment of "qualified" annuities is beyond the scope of this article and Rev. Proc. 2011-38.

3 *See* Rev. Proc. 2008-24, 2008-1 C.B. 684; Notice 2003-51, 2003-2 C.B. 361; Rev. Rul. 2003-76, 2003-2 C.B. 355. *See also* PLR 201038012 (June 22, 2010).

4 Unless otherwise indicated, each reference herein to a "section" means a section of the Internal Revenue Code of 1986, as amended.

5 Sections 1035(d)(1), 1031(b) and 1031(c); Treas. Reg. sections 1.1035-1 and 1.1031(b)-1(a).

6 *See* Kirk Van Brunt, *Revenue Procedure 2008-24 and Partial Annuity Exchanges: Where Are We?* 4 Taxing Times 5 (Sept. 2008) (discussing Rev. Proc. 2008-24 and related authorities); Walter Welsh and Mandana Parsazad, *ACLI Update Legislative and Regulatory Developments,* 7 Taxing Times 26 (Feb. 2011) (discussing PLR 201038012 (June 22, 2010)).

7 This example is based on one in Notice 2003-51.

8 Conway v. Commissioner, 111 T.C. 350 (1998), *acq.*, 1999-2 C.B. xvi.

9 The legislative history of section 1035 states that the provision is intended to apply to individuals "who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. no. 83-1337, at 81 (1954).

10 AOD 1999-16. The Service generally has discretion to issue an Action on Decision (or AOD) on unappealed court cases that were decided against the government. Unlike a revenue ruling or revenue procedure, an AOD is not intended to serve as public guidance and cannot be cited as precedent. Rather, AODs are relied upon within the Service only as conclusions applying the law to the facts in the particular case at hand. "Acquiescence" to a court decision in an AOD generally means that the Service accepts the court's holding in the case and will follow that holding in disposing of cases with the same controlling facts. *See, e.g.*, 1999-2 C.B. xvi (describing the effect of an AOD and acquiescence).

11 2003-2 C.B. 361. In conjunction with Notice 2003-51, the Service also issued Rev. Rul. 2003-76, 2003-2 C.B. 355, which (1) confirms that section 1035 will apply to a partial exchange with facts similar to those in *Conway*, and (2) clarifies that "basis" and "investment in the contract" are each allocated ratably between the contracts involved in a partial exchange, based on the percentages of the cash value retained and transferred (ignoring surrender charges). *See also* PLR 200342003 (July 9, 2003) (applying Rev. Rul. 2003-76).

12 The revenue procedure was effective for partial exchanges completed on or after June 30, 2008.

13 *See* section 72(q)(2)(D) and (I), respectively.

14 Rev. Proc. 2008-24 also clarified that, for partial exchanges falling within the safe harbor, the Service will not require aggregation of the contracts under section 72(e)(12), even if both contracts are issued by the same company, but instead will treat the contracts as separate annuity contracts.

15 For example, one of the conditions referenced in the guidance was section 72(q)(2)(F), which describes distributions "allocable to investment in the contract before August 14, 1982." Seemingly, this "condition" would "occur" on the date the investment in the contract was made, *i.e.*, sometime before Aug. 14, 1982. Thus, because Rev. Proc. 2008-24 was effective only for partial exchanges completed on or after June 30, 2008, it appeared that the section 72(q)(2)(F) condition could only occur *prior to* any partial exchange covered by the revenue procedure, and that the condition could never "occur between" the date of such a partial exchange and a subsequent distribution.

16 June 22, 2010.

17 Section 6110(k)(3).

18 *See* The Committee of Annuity Insurers, Survey of Owners of Non-Qualified Annuity Contracts, at 11 (The Gallup Organization and Mathew Greenwald & Associates, 2009) (available at http://www.annuity-insurers.org/annuities.aspx).

19 Section 72(a)(2), as added by Pub. L. No. 111-240 § 2113(a) (2010), effective for amounts received in tax years beginning after Dec. 31, 2010.

NAIC ADOPTS SSAP NO. 101—INCOME TAXES

By Richard Burness and Steven Sutcliffe*

The National Association of Insurance Commissioners ("NAIC") Statutory Accounting Principles Working Group ("SAPWG") issued a revised exposure draft of Statement of Statutory Accounting Principles ("SSAP") No. 101 on July 27, 2011. The revised exposure draft passed the SAPWG by a vote of 10 to 2 and subsequently passed the Financial Condition E Committee with only one "No" vote. SSAP No. 101 is the new standard which replaces the current temporary guidance set forth under SSAP No. 10R, which expires on Dec. 31, 2011.

Statutory accounting for income taxes has been the subject of considerable debate since the financial crisis began in 2008. Prior to the financial crisis, SSAP No. 10, the original codified SSAP standard for accounting for income taxes, remained relatively unchanged from its adoption in 2001. However, beginning in 2008, various states granted insurance companies permitted practices in determining the amount of deferred tax assets ("DTAs") they would be allowed to admit on their statutory annual statements. These practices generally allowed for greater admitted DTAs to be recorded on statutory annual statements than the initially allowed practices under SSAP No. 10.

Due to the increasing use and variety of permitted practices being applied under SSAP No. 10, and to address the apparent needs that resulted in such variation, the regulators proposed a temporary standard of accounting for income taxes under SSAP No. 10R. In particular, the accounting standard under SSAP No. 10R offered companies the ability to make an accounting election to increase the DTA realization or reversal period to three years, with a 15 percent capital and surplus limit. This reflected a change from the original SSAP No. 10 principles, which required a one-year DTA realization period, with a 10 percent capital and surplus limit.

The election was only available to property and casualty, health, and life insurance companies that met certain risk-based capital thresholds. Neither mortgage guarantee nor title insurance companies were eligible for the election under SSAP No. 10R as they are not subject to a risk-based capital threshold. The election was originally effective for 2009 and 2010 and was subsequently extended through December 2011.

While SSAP No. 101 maintains some of the changes found in SSAP 10R, including the possibility of a three-year DTA reversal period and a 15 percent surplus limit, it includes significant changes in statutory reporting for income taxes. Among the more noteworthy changes proposed in SSAP No. 101 are its provisions relating to tax contingency reserves, DTA admissibility and required disclosures. Some highlights of these changes are summarized below.

TAX CONTINGENCY RESERVES

Companies that are required to prepare financial statements under generally accepted accounting principles, or GAAP, are required to satisfy certain criteria in order to record the tax benefits, or the amount of tax benefits, associated with "uncertain tax positions." The rules, formerly known as Financial Interpretation No. 48, are contained in Accounting Standards Codification ("ASC") No. 740. Although SSAP No. 101 does not formally adopt the GAAP principles under ASC No. 740, it has significantly reduced the threshold for which recording a tax contingency reserve may be required.

More precisely, SSAP No. 101 replaces the standard set forth under SSAP No. 5, which required tax contingencies to be recorded using a *probable* and *reasonably estimated* criteria, with the standard under SSAP No. 5R, which requires tax contingencies to be recorded using a *more-likely-than-not* and *reasonably estimated* criteria.

In measuring the amount of the contingency reserve, the company must utilize management's best estimate. If the estimated tax loss contingency is greater than 50 percent of the original benefit recorded, a contingency reserve must be recorded in an amount equal to the full benefit recorded by the entity. Moreover, in conducting an analysis with respect to a given tax position, it must be presumed that the tax position will be examined by the taxing authority, and that the taxing authority will have full knowledge of the relevant facts.

Finally, tax contingency reserves related to timing items are not required to be "grossed up" unless an event has occurred that has given rise to a potential adjustment being issued by the taxing authority.

As a result of the reduced threshold and other changes relating to tax contingency reserves, insurance companies may need to reevaluate their tax positions to determine if SSAP No. 101 would require any adjustments to be made with respect to their current tax positions.

DEFERRED TAX ASSET ADMISSIBILITY

The DTA admissibility test under SSAP No. 101 is an area that garnered much public discussion. The impact of the changes noted below may require companies to examine their current accounting procedures to determine if any of the changes may impact the company's processes that are currently in place. These changes include:

- Repeal of the elective admissibility relief under SSAP No. 10R, which allowed a three-year reversal pattern of DTAs and a 15 percent surplus limitation if certain risk-based capital criteria were met. This repeal was replaced with a mandatory graduated admissibility calculation, as discussed below.

- Repeal of the requirement that the additional surplus resulting from the SSAP No. 10R election be held as appropriated surplus, not eligible for declaring dividends in certain states.

- Requirement that a statutory valuation allowance reduce gross assets recorded in the company's annual statement rather than being treated as a non-admitted asset.

- Formal adoption of the use of tax planning strategies in the determination of statutory valuation allowances and admissibility of DTAs consistent with ASC 740. This adoption helps bridge the gap between principles explicitly noted in ASC 740 and SSAP No. 101. Specifically, these principles include a requirement that tax planning strategies utilized must be prudent and feasible.

The DTA admissibility calculation under SSAP No. 101 is similar in principle and mechanics to the earlier tests under SSAP No. 10 and 10R. SSAP No. 101 takes a three-step approach, similar to the approach SSAP 10 paragraph 10(a), (b) and (c) outlines. SSAP No. 101, however, attempts to provide a greater admitted DTA for sufficiently capitalized entities, while addressing solvency concerns the SAPWG sought to deal with in SSAP No. 10R.

The three-step admissibility test allows an entity to admit DTAs that can be realized through recouping prior taxes paid, reducing future taxes expected to be paid, or offsetting future taxable income recorded as a deferred tax liability ("DTL"). These three steps are discussed in further detail below.

Step 1

Step 1 sets forth the test for admitting DTAs that can be carried back to taxes paid in prior years, similar to SSAP No. 10 paragraph 10(a). Due to the different carryback rules for certain entities and DTAs, there are a few items to take into consideration when admitting DTAs under Step 1. For example:

- The test requires consideration of a maximum three-year reversal pattern of DTAs.
- A DTA is admissible only to the extent taxes can be recovered in a time frame consistent with Internal Revenue Code carryback provisions. This will require entities to take into consideration the character of the DTAs reversing (ordinary vs. capital) as well as the carryback period allowed under the tax law.
- Consideration of a risk-based capital limitation is not needed
- Taxes deemed to be paid under step one of the admissibility test should include tax contingency accruals along with income taxes paid in prior year determinations.

Step 2

Step 2 of the admissibility test is also similar to SSAP No. 10 paragraph 10(b). Step 2 allows for the admissibility of reversing DTAs not admitted under Step 1, but only to the extent such amounts can be realized in future years and do not exceed a surplus limitation percentage. The surplus limitation percentage and the years in which DTAs may be realized are regulated by a solvency ratio developed by the SAPWG.

The solvency ratio is based on the entity's Authorized Control Level ("ACL") risk-based capital ("RBC") percentage, excluding any DTAs. This ratio is referred to as the "ExDTA ACL RBC" ratio in SSAP No. 101. The result is then mea-

CONTINUED ON **PAGE 14**

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sured against the industry table set forth below. Admissibility limits are either zero years and 0 percent of adjusted surplus, one year and 10 percent of adjusted surplus, or three years and 15 percent of adjusted surplus.

Realization Threshold Limitation Table—RBC Reporting Entities

ExDTA ACL RBC	Realized Years	Surplus Limitation
Greater than 300%	3 years	15%
200% – 300%	1 year	10%
Less than 200%	0 years	0%

Unlike SSAP No. 10R, financial/mortgage guaranty entities and other non-RBC reporting entities (e.g., title insurance entities) may be allowed an additional admitted DTA to the extent certain capital metrics are met. Additional realization threshold tables are noted under SSAP No. 101 for these entities. For financial/mortgage guaranty entities, the ratio of surplus (excluding DTAs) over policyholder and contingency reserves is used to calculate the admissibility limits. Other non-RBC reporting entities use the ratio of adjusted gross DTA (after valuation allowances) over capital and surplus as the metric for admissibility limits. Each type of entity is similarly allowed a three-year/15 percent, one-year/10 percent or 0-year/0 percent admissibility under Step 2, as follows:

Realization Threshold Limitation Table—Financial Guaranty or Mortgage Guaranty Non-RBC Reporting Entities

ExDTA Surplus/Policyholders and Contingency Reserves (%)	Realized Years	Surplus Limitation
Greater than 115%	3 years	15%
100% – 115%	1 year	10%
Less than 100%	0 years	0%

Realization Threshold Limitation Table—Other Non-RBC Reporting Entities (Predominantly Title Insurance)

Adjusted Gross DTA/Adjusted Capital & Surplus (%)	Realized Years	Surplus Limitation
0 – 50%	3 years	15%
51% – 75%	1 year	10%
Greater than 75%	0 years	0%

Step 3

Step 3 of the SSAP 101 test allows for the admissibility of any remaining DTAs to the extent DTLs are available to offset the DTA. This is similar to SSAP No. 10R paragraph (c).

This step requires consideration of the character of the DTAs and DTLs. In this regard, it is consistent with tax law, which, for example, does not allow ordinary DTLs to offset capital DTAs.

SSAP 101 also provides that a reporting entity shall consider the reversal pattern of temporary differences. This consideration only requires a scheduling exercise if scheduling is needed for valuation allowance purposes and, as a result, should be consistent with the mechanics for determining any statutory valuation allowance which occurs prior to performing the admissibility test.

DISCLOSURES

Unlike what occurred with respect to the adoption of SSAP No. 10R, SSAP No. 101 does not include significant changes to the income tax footnote disclosures. The regulators determined to keep the enhanced disclosure under SSAP No. 10R, with only a few additional disclosures being required.

Under SSAP No. 101, companies will now be required to disclose whether any benefits being recognized as a result of tax planning strategies are related to reinsurance transactions. This disclosure is in addition to the current tax planning disclosure required under SSAP 10R.

In addition, a new disclosure will be required that identifies any tax contingency reserve with respect to which it is deemed

to be reasonably possible that the total liability will significantly increase within 12 months of the reporting period. The reporting entity will need to disclose an estimate of the range or a statement that a range cannot be made.

CONCLUSION

SSAP No. 101 has many characteristics of the prior accounting principles for income taxes for insurance companies. However, there are many intricacies and steps that will need to be considered.

So, although the issuance of SSAP No. 101 ends a period of uncertainty relating to statutory accounting for income taxes, there is still uncertainty as to how SSAP No. 101 will affect each entity's specific fact pattern. To assist in the transition to the new standard, the NAIC has indicated a revised SSAP No. 10 Questions and Answers will be updated for the new SSAP No. 101 guidance. It is also anticipated that the NAIC will draft an Issue Paper discussing the rationale and bases for its conclusions under SSAP No. 101.

Nevertheless, financial reporting departments will need to be cognizant of the potential changes as they begin their financial reporting and internal control processes for 2012.

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END NOTES

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THE INTERACTION OF SECTION 7702 AND THE NONFORFEITURE LAW: TROUBLE AHEAD FOR TRADITIONAL LIFE INSURANCE?

By Benjamin J. Yahr and Christian DesRochers

Section 7702 imposes two requirements that a contract must satisfy in order to be treated as a life insurance contract under the Internal Revenue Code (the "Code"). First, the contract must be a life insurance contract under the "applicable law." Second, the contract must meet at least one of two alternative actuarial tests, either the cash value accumulation test (CVAT) or the guideline premium limitation and cash value corridor test. As will be discussed in this article, the interaction of the section 7702 CVAT and state nonforfeiture laws (SNFLs) create a dual limitation on traditional life insurance contracts, with the CVAT limiting the maximum permissible cash value and the SNFL requiring a minimum cash surrender value. In effect, the nonforfeiture standards act as a "floor," while the section 7702 limitations serve to create a "ceiling" on permissible cash surrender values. In cases where the "floor" is above the "ceiling," a policy design cannot simultaneously satisfy both the state law nonforfeiture requirements and federal tax requirements for life insurance tax treatment. This dual limitation effectively eliminated from the market some of the plans that were sold before the effective date of section 7702 in 1984. Historically this generally resulted from limiting the permissible endowment periods or death benefit patterns (*i.e.*, non-increasing) under the section 7702(e) computational rules, and not from the assumed interest rate. Thus, to date at least, section 7702 has typically not limited the sale of traditional "mainstream" permanent life insurance products. This article discusses the interaction of the section 7702 and nonforfeiture interest rates, and examines the possibility that traditional life insurance policies will, at some point in time, fail to qualify under the CVAT.

CVAT REQUIREMENTS AND THE NONFORFEITURE LAW

In order to meet the requirements of the CVAT, by the terms of the contract, the cash surrender value under the contract can at no time exceed the net single premium (NSP) required to fund the future insurance benefits to be provided under the contract.[1] A key element of the CVAT is that compliance must be by the *terms of the contract*. The actuarial limitations under section 7702 interact with the minimum nonforfeiture requirements of state law.[2] When the limitations were enacted in 1984, they were intended, in part, to accommodate many then-existing life insurance products (and to deny life insurance treatment for others). As a consequence, this interaction is quite natural and, in fact, necessary. By creating a limitation that mirrors the nonforfeiture law, the actuarial standards in section 7702 codified many, but not all, policy designs that existed at the time section 7702 was enacted.

Standards limiting the mortality and interest assumptions permitted in computation of the allowable values, along with the future benefits to be taken into account, are used to give the limitations full meaning. By explicitly limiting the actuarial assumptions and the pattern of benefits to be used in the calculation, Congress prohibited the use of certain assumptions, such as very low interest rates, highly substandard mortality on standard cases, short endowment periods, and increasing death benefits that would increase the cash value relative to the death benefit and thereby undermine the purpose of the tests.

Minimum cash value requirements under the SNFL are computed using:

1. The pattern of guaranteed future benefits under the contract.
2. The contract nonforfeiture rate subject to statutory maximum interest rates.
3. Nonforfeiture mortality assumptions.

In contrast, the section 7702 definitional limitations are based on:

1. Generally non-increasing future benefits.
2. The contract nonforfeiture interest rate subject to a statutory minimum assumption (4 percent in the case of the CVAT).
3. "Reasonable" mortality assumptions.[3]

Although the section 7702 requirements are in some ways a "mirror image" of the nonforfeiture laws, one way in which they differ is the determination of the applicable interest rate. First, there is a tension between the tax law minimum and the nonforfeiture maximum with respect to the interest rate for traditional life insurance plans, as a lower interest rate increases the net premiums and cash values, while a higher rate conversely reduces net premiums and cash values. Thus, section 7702 seeks to set a minimum interest rate to limit permissible cash values, while the nonforfeiture law looks toward a maximum permissible rate to require minimum cash values. Second, the respective rates are set in a different way. While nonforfeiture interest is tied to the valuation rate, which in turn is based on Moody's Corporate Average, the section 7702 rates are fixed by statute at not less than 4 percent under the CVAT. In the current interest environment, if the maximum nonforfeiture interest rate falls below 4 percent, a traditional life insurance policy would not simultaneously meet the dual limitation.

DETERMINATION OF THE NONFORFEITURE INTEREST RATES

Maximum nonforfeiture rates under the SNFL are equal to 125 percent of a contract's valuation rate (rounded to the nearest ¼ percent). The valuation rates (I) are in turn based on a contract's calendar year of issue, using a formula based on Moody's Corporate Average:

$$I = 3\% + W \times (R1 - 3\%) + (W/2) \times (R2 - 9\%)$$

Where: W is a weighting factor based on the guaranteed duration of the contract (*i.e.*, the maximum number of years a contract can remain in force under its guarantees). It is equal to 35 percent for life insurance plans with guaranteed durations of 20 years or more.

R is the reference interest rate, equal to the lesser of the 36-month or 12-month average of the Moody's Corporate Average ending on June 30 of the year preceding the contract's issue year; R1 is the lesser of R and 9 percent, while R2 is the greater of R and 9 percent.

Thus, if R is equal to 6%, I equals 3% + 35% x (6% - 3%) = 4.05%, which is 4.00% when rounded to the nearest ¼ of 1 percent. However, no change is made to the valuation rate unless it represents a ½ percent change from the prior calendar year's rate. Currently, the maximum valuation rate (through 2012) for guaranteed durations of more than 20 years is 4 percent, while the corresponding nonforfeiture rate is 5 percent.

HISTORICAL APPLICATION OF THE NONFORFEITURE INTEREST FORMULA

To provide a long-term view of the operation of the formulaic nonforfeiture interest rates, historical interest rate data was used to compute the rates which would have resulted had the

EXHIBIT 1
Formula (Unrounded) Nonforfeiture Interest Rates

CONTINUED ON **PAGE 18**

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formula been applied for years prior to the adoption of the dynamic valuation and nonforfeiture rates through the 1980 Amendments to the Standard Valuation and Nonforfeiture Laws, as well as the years since.[4]

As Exhibit 1 indicates, the (unrounded) formula rates have been declining since early 1983 where the formula rates peaked at 7.5 percent. Note that it was during this period that the statutory rates under section 7702 were enacted. This provided a "spread" between the section 7702 CVAT rate and the nonforfeiture rate that has largely disappeared. At present, the formula nonforfeiture rate is slightly less than 5 percent. However, the formula rate would have been below 4 percent from 1941 to 1957. Using the historical rates as the base, it is clear that a long period of low interest rates is necessary to produce formulaic nonforfeiture rates less than 4 percent.

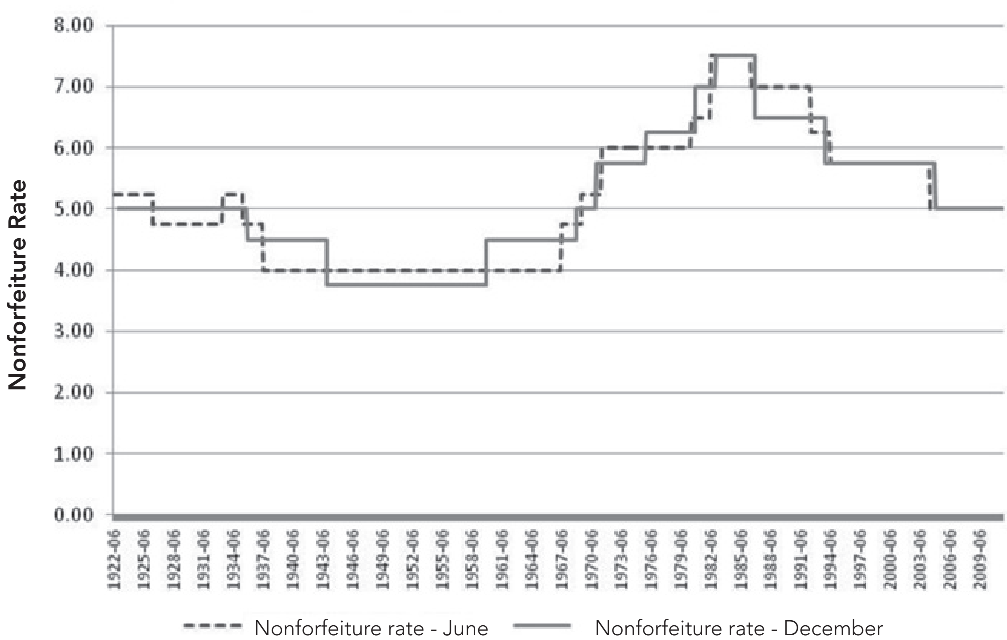
Another interesting item to consider is the interaction of rounding to the nearest ¼ of a percent and the ½ percent change threshold, which is illustrated in Exhibit 2. If we apply both conditions and use June as the determination month consistent with the SNFL requirements (see the dashed line in Exhibit 2), the (rounded) formula nonforfeiture rate does not dip below 4 percent. However, if we use December as the determination month (see the solid line in Exhibit 2), the nonforfeiture rate is 3.75 percent from 1943 to 1959.

CONCLUSION

Given the historical precedent, it is certainly possible for a conflict to occur between the CVAT minimum interest rate and the nonforfeiture maximum interest rate, thus eliminating traditional life insurance from meeting the definition of life insurance under the Code. However, there is also an answer to the potential problem. With the development of the valuation manual for principle-based reserves (PBR), a change in the SNFL has been proposed by the NAIC to set a contract's nonforfeiture rate through the valuation manual, thus de-linking the valuation and nonforfeiture rates.[5] The change would be effective "on or after the operative date of the valuation manual." Thus, although enacted for a different reason, a solution to the potential problem may be as simple as flooring the maximum formulaic nonforfeiture rate for life insurance policies to 4 percent through the operation of the valuation manual, which would eliminate the possibility of a conflict with the CVAT rates, and unlike a change to section 7702, appears to be already incorporated in the proposal for setting the valuation

EXHIBIT 2

Formula (Rounded) Nonforfeiture Interest Rates



interest rates as a part of changes needed to accommodate PBR. Working through the states to change the SNFL, rather than trying to enact a change in section 7702, seems a simple and safer approach to the problem, given the difficulty of enacting any tax legislation in the current political environment.

The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

END NOTES

[1] *See* IRC § 7702(b)(1).

[2] *See* S. Rpt. No. 98-169, at 573-74 (1984) (stating that, for purposes of section 7702, "rate or rates guaranteed on the issuance of the contract" means "the interest rate or rates reflected in the contract's nonforfeiture values assuming the use of the method in the Standard Nonforfeiture Law.").

[3] Reasonable mortality for any given contract is, by statute, generally prohibited from exceeding mortality determined using the section 807(d) "prevailing commissioners' standard tables" (CSO) for mortality and morbidity as of the time of the contract's issuance, unless Treasury Regulations prescribe otherwise. The prevailing tables are the most recent tables prescribed by the NAIC and allowed to be used for valuation purposes in at least 26 states.

[4] For the analysis, the Moody's Corporate Average was approximated as the average of the Moody's Aaa and Baa rates, as reported on FRED, the website of the Federal Reserve Bank of St. Louis. The rates shown were not rounded, and are reported as monthly values.

[5] Revisions to Model 808, NAIC Draft, 8/2/11.

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IRS LB&I DIVISION ISSUES GUIDANCE TO EXAMINERS ON THE CODIFIED ECONOMIC SUBSTANCE DOCTRINE

By Samuel A. Mitchell

In March 2010, Congress codified the judicial economic substance doctrine in an effort to raise revenue as part of the health care reform legislation.[1] The law provides for strict liability penalties of 20 percent for understated taxes and refund claims that result from transactions that lack economic substance.[2] The strict liability understatement penalty increases to 40 percent for positions the taxpayer does not properly disclose on its tax returns.[3] The Staff of the Joint Committee on Taxation estimated that the effect of codifying the doctrine and imposing the associated penalties will generate approximately $5 billion in tax revenues over the 10 years from 2010 to 2019.[4] This relatively small amount of tax revenue may seem insignificant in the light of health care reform and the overall federal budget over a 10-year period. However, it is difficult to understate the concern that the strict liability penalty aspect of the economic substance legislation has caused among corporate taxpayers, tax planners and advisors. The judicial economic substance doctrine historically created great uncertainty for taxpayers, and for agents charged with enforcement, because it was difficult to predict how the courts would apply it to particular transactions.

Unfortunately, the language of the new code provision does not do much to provide comfort or guidance to taxpayers or agents as to its scope. The code section expressly incorporates by reference from the courts the common law definition of the doctrine of economic substance to the extent the case law is not inconsistent with the new code provision.[5] In addition, the section provides that "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."[6] Despite numerous requests for Internal Revenue Service (IRS) written guidance, the IRS Chief Counsel's Office has consistently stated that additional public guidance on when the doctrine is relevant and applicable would not be forthcoming. For example, in Notice 2010-62, released on Sept. 13, 2010, IRS Chief Counsel provided limited guidance on the disclosure requirements and the application of penalties and sought comments regarding the disclosure requirements, but nevertheless stated that "[t]he Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."[7]

This void in guidance regarding the application of the codified economic substance doctrine has been filled, in a more indirect manner, in the form of instructions to IRS auditors. In July 2011, the commissioner of the Large Business and International Division (LB&I) of the IRS evidently recognized this state of uncertainty and issued very helpful guidance to all LB&I examiners.[8] The LB&I Directive provides examiners with a four-step framework for applying the doctrine and requires them to seek guidance from local managers and counsel and obtain approval from a Director of Field Operations (DFO; a high-level IRS manager) in all cases before applying the doctrine.[9]

Before considering the substance of the LB&I Directive, it is useful to review the codification provision to understand the uncertainty inherent in the application of the judicial doctrine. In summary, the codified economic substance doctrine provides that a transaction will not be treated as having economic substance for tax purposes unless (1) it changes the taxpayer's economic position "in a meaningful way" apart from federal income tax consequences, ***and*** (2) the taxpayer had a "substantial purpose" for entering the transaction apart from federal income tax consequences.[10] If a taxpayer relies on the profit potential to pass this conjunctive test, the new section clarifies that the present value of the "reasonably expected pre-tax profit" potential must be "substantial" in relation to the expected tax benefits. Given the fact that the doctrine incorporates by reference a large, amorphous body of common-law cases and turns on such words as "meaningful," "substantial" and "reasonably expected," it is easy to see how inconsistently it could be administered from agent to agent and taxpayer to taxpayer.

More importantly, there has been substantial uncertainty regarding the threshold question of whether the doctrine is even relevant to particular situations, and the doctrine as codified does little to resolve this uncertainty. Traditionally, the

CONTINUED ON **PAGE 22**

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doctrine of economic substance was applied in cases where taxpayers sought to take advantage of tax incentives or tax benefits that were based on literal provisions in the Internal Revenue Code (the "Code") but that Congress nevertheless did not intend to be extended as far as the particular transaction at issue. The line was drawn by the courts at the limit of congressional intent. The Supreme Court, in *Gregory v. Helvering,* described the operative question as follows: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[11] This line-drawing exercise between the literal language in the Code and the limits of congressional intent has always created uncertainty. The Tax Bar and others have requested "angel lists" of transactions that will be respected, but IRS Chief Counsel has not provided any such guidance.[12]

The LB&I Commissioner's Directive goes a long way to address the potential for inconsistent administration of the economic substance doctrine and its inherent uncertainty by providing a workable and easy-to-understand four-part framework for its application. First, the Directive requires an agent to evaluate whether the application of the doctrine is "likely not appropriate" in light of facts and circumstances derived from case law and prior administrative sources that tend to indicate that the application of the doctrine is not appropriate. The Directive lists 18 facts and circumstances to consider. A few examples include that the transaction: was not "promoted/developed/administered" by the company's tax department or tax advisors, was not "highly structured," contains no "unnecessary steps," does not "accelerate a loss or duplicate a deduction," and was not "outside the taxpayer's ordinary course of business." Additionally, the Directive identifies four situations in which the application of the doctrine is likely not appropriate: (1) if the transaction involves a choice between capitalizing a business enterprise with debt or equity; (2) if the transaction involves a choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) if the transaction or series of transactions constitute a corporate organization or reorganization; or (4) if the transaction involves the choice to use a related party and the arm's-length standard for transfer pricing under section 482 is met.

Second, if the IRS agent has considered all of the facts and circumstances described in the first step and still thinks that it may be appropriate to apply the doctrine of economic substance, the agent must consider facts and circumstances that indicate that it is appropriate to apply the doctrine. The Directive provides 17 facts and circumstances that are the inverse of the factors considered in the first step. For example, if the transaction is "promoted/developed/administered" by the company's tax department or tax advisors, this is a factor that may indicate it is appropriate to apply the doctrine.

Third, after the agent analyzes the first two steps and determines that it may be appropriate to apply the doctrine of economic substance, the agent must answer seven numbered questions. If the answer to any of the questions 1 through 4 or 7 is "yes," the agent must consult with a local manager and local counsel before pursuing the application of the doctrine any further. If the answer to question 5 or 6 is "yes," the agent is instructed not to apply the doctrine. Discussion of all the questions is beyond the scope of this article, but there are some interesting and revealing things about the two categories of questions that are worthy of note here. One particularly interesting example is question number 7, which reads as follows: "In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel." Taxpayers have complained for years that the IRS uses the economic substance doctrine as a sledgehammer to attack tax-motivated transactions when technical arguments involving the operative Code provisions would suffice. It is encouraging to corporate taxpayers that the LB&I Commissioner's Directive requires agents to consider whether the application of the doctrine better serves tax administration than a technical argument and to involve management and counsel in the decision.

Other particularly noteworthy questions the agent must address in step 3 of the overall framework are questions 5 and 6, which require the agent to consult a local manager and counsel to consider whether other judicial doctrines that are similar to the economic substance doctrine (question 5) or re-characterization of the transaction (question 6) are more appropriate to the circumstances than the economic substance doctrine. If upon consultation with a manager and local counsel the agent determines that the use of a similar judicial doctrine (*e.g.*, substance over form or step-transaction) or re-characterization (*e.g.*, from debt to equity) would be more appropriate than the economic substance doctrine, the agent is instructed not to apply the economic substance doctrine. These restrictions on agents' authority are noteworthy because they narrow the scope of the strict liability penalty provisions that were passed along with the codification of the economic substance provision. New Internal Revenue Code section 6662(b)(6) provides for a strict liability penalty for an underpayment attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) ***or failing to meet the requirements of any similar rule of law***."[13] The excessive refund penalty provision at Internal Revenue Code section 6676(c) incorporates this language by reference, making it clear that strict liability applies in the refund penalty setting as well. The highlighted language in the section 6662(b)(6) strict liability provision arguably refers to the application of similar doctrines like the step-transaction doctrine or re-characterization that often are applied by courts in tandem with the economic substance doctrine. At least for the time being, LB&I, through its Directive, has limited its discretion to apply the economic substance doctrine strict liability penalty when application of other judicial doctrines or re-characterization would be more appropriate.

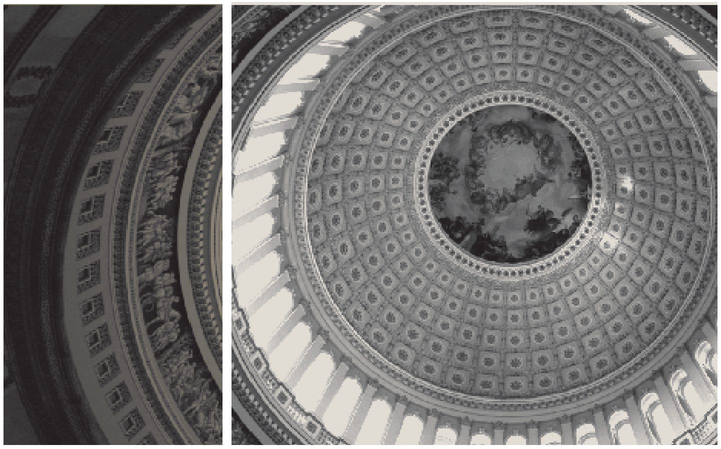
The fourth and final step in the LB&I Directive requires an agent in consultation with a local manager and counsel to submit a written application to the DFO detailing how the factors in steps 1 and 2 were considered and how the questions in step 3 were answered before the doctrine can be applied. The ultimate decision whether to apply the doctrine resides with the DFO, but the DFO must consult with counsel and give the taxpayer an opportunity to respond before finalizing the decision.

At least for the time being, LB&I, through its Directive, has limited its discretion to apply the economic substance doctrine strict liability penalty when application of other judicial doctrines or re-characterization would be more appropriate.

The detailed and iterative process and multiple levels of review, consultation and approval required in the LB&I Directive should give large corporate taxpayers some comfort that LB&I agents will appropriately exercise discretion and restraint in applying the codified doctrine of economic substance. Furthermore, taxpayers should be pleased that the Directive effectively limits the strict liability penalties to cases in which other judicial doctrines or approaches such as re-characterization are not more appropriate than economic substance. The Directive reflects well on current IRS management. However, taxpayers should note that the Directive is not formal guidance and can be revoked, expanded or otherwise changed at any time. ◂

END NOTES

1 Health Care and Education Reconciliation Act of 2010, Pub. Law. No. 111-152.
2 *See* I.R.C. § 6662(b)(6) for underpayment penalties and I.R.C. § 6676(c) for refund claim penalties. The underpayment penalty is a strict liability penalty pursuant to I.R.C. § 6664(c)(2), which provides that a reasonable cause defense *does not apply. The refund penalty is a strict liability penalty pursuant to I.R.C. § 6676(c), which provides as a matter of course that a tax position that lacks economic substance does not have a reasonable basis.*
3 *See* I.R.C. § 6662(i).
4 *See* Joint Committee on Taxation Staff Explanation of Tax Legislation Enacted in the 111th Congress, Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 111th Congress.
5 *See* I.R.C. § 7701(o)(5)(A), defining the doctrine as follows: "The term 'economic substance doctrine' means the common-law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks business purpose."
6 I.R.C. § 7701(o)(5)(C).
7 Notice 2010-62, 2010-40 I.R.B. 411 (Sep. 13, 2010). This Notice prompted a flurry of comments, including comments from the American Bar Association, *http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2011/011811comments.authcheckdam.pdf;* the New York Bar Association, *http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1228-rpt.pdf;* and the American Institute of Certified Public Accountants, *http://www.aicpa.org/InterestAreas/Tax/Resources/StandardsEthics/OtherAICPAStandardsEthicsRules/DownloadableDocuments/Economic_Substance_Comments.pdf.*
8 *See* LB&I Directive for Industry Directors, LB&I Control No: LB&I-4-0711-015 (July 15, 2011), from Heather C. Maloy, Commissioner, Large Business & International Division.
9 An earlier Directive issued on Sept.14, 2010, (LB&I Directive, LMSB-20-0910-024), required examiners to obtain approval from their Director of Field Operations before imposing a penalty based on the economic substance doctrine. Interestingly, this earlier Directive was issued one day after Notice 2010-62, in which Chief Counsel gave notice that Treasury and the IRS would not issue guidance on the types of transactions to which the doctrine would be applied. *See supra.*
10 *See* I.R.C. § 7701(o)(1)(A) and (B).
11 293 U.S. 465, 469 (1935) (citations omitted).
12 *See, e.g.,* the comments from the New York Bar Association, American Institute of Certified Public Accountants, and New York Bar Association referenced above in Note 7.
13 I.R.C. § 6662(b)(6) (emphasis added).



A MYSTERY PARTIALLY UNVEILED: THE IRS RULES ON SECTION 7702A'S NECESSARY PREMIUM TEST

By John T. Adney, Craig R. Springfield and Adam C. Harden

In private letter ruling ("PLR") 201137008, dated June 14, 2011 and released to the public on Sept. 16, 2011, the Internal Revenue Service (the "Service") issued its seminal ruling interpreting Internal Revenue Code section 7702A(c)(3)(B)(i),[1] commonly referred to as the "necessary premium test" or "NPT." The Service responded to a life insurance company's request that it be allowed to take certain expense charges into account in determining the "deemed cash surrender value" of a universal life insurance policy for purposes of the NPT, compliance with which might ultimately affect whether a policy is a "modified endowment contract" ("MEC") under section 7702A. In this PLR, the Service concluded that "reasonable expense charges" are properly taken into account in determining the deemed cash surrender value, which must be calculated in order to apply the NPT to a life insurance contract intended to satisfy the cash value accumulation test ("CVAT") of section 7702(a)(1) and (b). In reaching this decision, the Service reviewed various parts of section 7702A and relied heavily on the legislative history of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"),[2] which enacted the provision.

STATUTORY BACKGROUND AND FACTS OF THE RULING

Under section 7702A, increases in a policy's death benefits and in qualified additional benefits such as term life insurance riders covering family members ("QABs") are considered "material changes" subject to the rule in section 7702A(c)(3), which requires a reapplication (under special rules) of the premium limit established by section 7702A's "7-pay test." This reapplication of the 7-pay test can result in the policy's treatment as a MEC, thus subjecting distributions (including loans) from the policy during the insured's lifetime to a less favorable income tax regime than applies to a policy that is not a MEC (a "non-MEC").

The purpose of the NPT is to shelter certain death benefit increases from material change status, avoiding the 7-pay test's reapplication on their account. The kinds of death benefit increases intended to be sheltered by the NPT include paid-up additions purchased by policyholder dividends under participating whole life insurance policies and, in the case of interest-sensitive whole life and universal life policies, death benefit increases resulting from the application of one of section 7702's minimum risk corridors when excess interest or earnings are credited or less-than-guaranteed charges are assessed.[3] The NPT also shelters death benefit increases under certain increasing death benefit patterns, such as under a so-called "option 2" death benefit where the death benefit equals the sum of a fixed amount of pure insurance and the policy's cash value. The condition imposed by the NPT for obtaining such shelter is that premiums must not have been paid for the policy higher than the cumulative amount needed to fund the lowest death benefit and QABs under the policy, *i.e.*, the "necessary premiums." For a CVAT policy, the legislative history of TAMRA, as further described below, generally defines a premium to be "necessary" if its amount is within the excess of the section 7702 net single premium for the policy (calculated assuming only the lowest benefits during the 7-pay period) over what it labeled the "deemed cash surrender value" of the policy.[4]

The purpose of the NPT is to shelter certain death benefit increases from material change status, avoiding the 7-pay test's reapplication on their account.

PLR 201137008 dealt with a universal life policy which it said would comply with the CVAT by providing a minimum death benefit equal to the product of the policy's cash surrender value (within the meaning of section 7702(f)(2)(A)) and a corridor factor that varied with the age and certain other characteristics of the insured. The policy, typical of universal life, provided for flexible premium payments, planned periodic premiums that may be paid, and an adjustable death benefit.

The PLR's statement of facts posited that the policy could be sold as either a MEC or a non-MEC. In circumstances where a policyholder desired the policy not to be or become a MEC, the insurer would identify, and the policyholder would pay, premiums intended to comply with the 7-pay test of section 7702A, thereby avoiding MEC status. Presumably because the policy's death benefit could increase due to its minimum death benefit provision and thus potentially could undergo material changes subject to the rule in section 7702A(c)(3), the insurer would need to apply the NPT to determine if a post-issuance material change arose under the policy. In turn, to apply the NPT, the insurer would need to know how to compute the policy's deemed cash surrender value for purposes of satisfying the NPT, raising the particular question presented to the Service in the insurer's PLR request. This question was: Can the expense charges related to the policy be deducted in computing that deemed cash surrender value?

The PLR indicated that the company represented to the Service that the expenses the insurer proposed to reflect in computing the deemed cash surrender value would satisfy the so-called reasonable expense charge rule of section 7702(c)(3)(B)(ii).

THE RULING AND ITS RATIONALE

In PLR 201137008, the Service issued the following ruling to the insurance company:

> For purposes of the necessary premium test under section 7702A(c)(3)(B)(i), reasonable expense charges are taken into account when determining the deemed cash surrender value of a policy intended to satisfy the Cash Value Accumulation Test under section 7702(b).

To reach this conclusion, the Service began its analysis by looking to subsections (a)(1), (b), (c)(3)(A), and (c)(3)(B) of section 7702A, which dictate the MEC status (or not) of section-7702-compliant life insurance policies entered into on or after June 21, 1988. As highlighted in the PLR's analysis, the statutory provisions yielded but little insight into the elements or operation of the NPT, and they mentioned the deemed cash surrender value not at all. Insight was provided, however, in the legislative history accompanying the enactment of section 7702A, and so the PLR's analysis relied heavily on this legislative history. (While the PLR did not say so, there are no regulations describing the NPT, a circumstance not unusual where sections 7702 and 7702A are concerned.)

The Service's analysis in the PLR next observed that the Conference Committee report on TAMRA, like section 7702A(c)(3)(B)(i) itself, implied that the purpose of the NPT is to allow for the payment of premiums "necessary to fund" a policy's future benefits—as defined in section 7702, these consist of the policy's death benefit, its endowment benefit, and the costs of any QABs—if those premiums must be paid to keep the policy in force.[5] The discussion in the PLR subsequently returned to this point, noting that a footnote in the Conference report instructs that if a policy's deemed cash surrender value exceeds its actual cash surrender value, the latter should be substituted for the former in the necessary premium calculation.[6] These observations helpfully framed the objective of the PLR exercise: to craft an answer to the insurer's question that would enable premiums to be paid to fund the policy adequately without creating a MEC.

To define the operation of the deemed cash surrender value in particular, the Service then looked to the report of the House Ways and Means Committee on TAMRA

To define the operation of the deemed cash surrender value in particular, the Service then looked to the report of the House Ways and Means Committee on TAMRA.[7] That report described the deemed cash surrender value as:

> the cash surrender value (determined without regard to any surrender charge or policy loan) that would result if the premiums paid under the contract had been credited with interest at the policy rate and had been reduced by the applicable mortality and expense charges. For this purpose, in the case of a contract that satisfies the [CVAT], the policy rate equals the greater of 4 percent or the rate or rates guaranteed on the issuance of the contract.... The applicable mortality and expense charges for any contract are those charges that were taken into account for prior periods under the [CVAT]….[8]

The Service construed these statements to mean that a policy's deemed cash surrender value is calculated, to use the words of the PLR, "by accumulating premiums actually paid for the contract, net of expense charges specifically imposed against those premiums, at the minimum interest rate or rates assumed to be credited (the contractually guaranteed rate(s) or, if greater, the statutory minimum rate of 4 percent) less the mortality and expense charges that would be assessed against the cash surrender value." According to the PLR, the statements in the Ways and Means Committee's report demonstrated that the deemed cash surrender value for a policy is properly computed

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by taking into account the expense charges imposed under the policy, specifically in that the statements speak to the calculation of a cash surrender that, as of any point in time, is assured to be available to fund the policy's future benefits. The Service further reasoned, adverting to the Conference report's footnote mentioned above, that it would not be logical to allow a policy's actual cash surrender value, which obviously would be reduced by the policy's expense charges, to be used as a substitute for the deemed cash surrender value if the expense charges were not allowed to be taken into account for the latter. Congress, in other words, should not be assumed to have intended such an asymmetry.

Thus, the Service stated in the PLR that "if expense charges are taken into account in determining the cash surrender value of a CVAT contract, it is appropriate to reflect them in the deemed cash surrender value calculation." Also, in the case of the policy involved in PLR 201137008, the expense charges were said to be assessed against the premiums that entered into the determination of the policy's cash value. The Service thus held that it is appropriate to reflect the expense charges (which were represented to be reasonable) in the deemed cash surrender value of the policy for purposes of the NPT.

CONCLUSION

By issuing PLR 201137008, the Service made its initial foray into the land of the NPT—territory now being charted more broadly by the Necessary Premium Task Force of the Society of Actuaries' Taxation Section. In the PLR, the Service clarified that in applying the NPT to a CVAT policy, the deemed cash surrender value of the policy should be computed by taking into account the expense charges that are imposed under the policy—at least to the extent that the charges are "reasonable" within the meaning of section 7702(c)(3)(B)(ii). In so holding, the Service produced a ruling that reached a conclusion both logical and consistent with the stated goal of the authors of the TAMRA rules.

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END NOTES

1 Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

2 Pub. L. No. 100-647 (1988).

3 In addition to the provisions in the TAMRA legislative history discussed below, the Senate Finance Committee, in describing the material change rules and the NPT, noted that policyholder dividends would be considered "other earnings" that may increase the death benefit without triggering a material change. 134 Cong. Rec. S 12352, at 12353 (daily ed. Sept. 12, 1988).

4 Specifically, the TAMRA legislative history describes a "necessary premium" with respect to a policy that satisfies the CVAT in the following words:

> A premium is necessary to fund the lowest death benefit payable during the first 7 contract years to the extent that the net amount of the premium (i.e., the amount of the premium reduced by any expense charge) does not exceed the excess, if any, of (1) the attained age net single premium for the contract immediately before the premium payment, over (2) the deemed cash surrender value of the contract immediately before the premium payment.

H.R. Rep. No. 100-1104 (Conf. Rep.), at 104-105 (footnotes omitted) (the "TAMRA Conference Report").

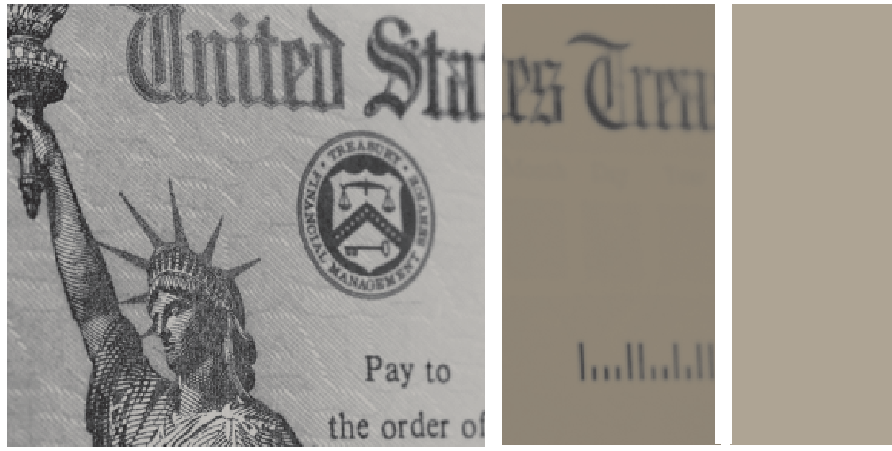
5 *See id.*

6 TAMRA Conference Report, at 105, n. 3. The deemed cash surrender value and its actual counterpart will not always be equal; otherwise, a reference to a "deemed cash surrender value" would be unnecessary. The actual may exceed the deemed because, *e.g.*, the deemed cash surrender value is determined using only the rate or rates guaranteed on issuance or 4 percent, if greater, whereas the actual cash surrender value may be credited with "excess" interest or earnings. On the other hand, in the case of a variable contract, the underlying separate account investments may lose value, causing the actual to be less than the deemed cash surrender value.

7 H.R. Rep. No. 100-795, at 481 (1988).

8 *Id.*

TAX CONSIDERATIONS IN ACTUARIAL PROJECTIONS



By Edward Robbins and Stephen R. Baker

This article speaks to a major component of actuarial projections that often receives insufficient attention by actuaries.

When making projections, an actuary must sort out the items of little consequence from those that make a significant difference, and those items that are determinable within reasonable ranges from those that are not readily quantifiable. Federal income taxes are significant, the largest single home office expense in many companies. Further, despite the continual evolution of tax guidance over the years, most of the changes have been interpretive, the relevant sections of the Internal Revenue Code (the Code) changing little over the last 20 years.[1] Thus, the effect of taxes has been relatively quantifiable. While the Code could undergo fundamental changes as it affects U.S. life insurers (certainly a possibility, given the impending International Financial Reporting Standards, among other influences), certain elements have been in place without change for many years, and are unlikely to change. These include the cost basis of invested assets and the loss carryforward and carryback rules. Indeed, it would appear that predictability of federal income tax guidance may be far simpler than predictability of the stock market (though still potentially problematic).

In setting projection assumptions, actuaries pay a lot of attention to factors such as equity growth and policyholder behavior—and well they should. However, certain significant tax issues may tend to be ignored. The time appears ripe for refinement of the tax assumptions in two ways:

- Sensitivity testing for the more probable future changes in tax guidance, just as sensitivity testing is generally performed on certain other assumptions deemed significant; and
- Arguably more pertinent, dealing with the current guidance in a more sophisticated manner.

This article deals with the second of these two issues.

Defensible algorithms with respect to tax reserves, other tax cash flows, and admissible deferred tax balances should be a necessary part of such projections. Yet the current level of sophistication of the tax module varies widely from company to company. While most companies generate tax reserves as well as statutory reserves, some do not. Further, many significant issues are, more often than not, ignored in the modeling process. A common trend is to generate taxable income equal to statutory income, with possible exceptions for:

- Replacement of statutory reserve incidence with tax reserve incidence, and
- Section 848 tax DAC.

The following is a list of the areas of tax calculation that are generally not well developed, if they exist at all, in the actuarial projection process:

- Operating loss deductions (OLD)[2] and net operating loss carrybacks and carryforwards (NOLs), and the restrictions on their utility depending on the company fact pattern;
- Capital loss carrybacks and carryforwards, with even greater restrictions than NOLs;
- Cost basis of invested assets for determining taxes at disposal dates;
- The effect of certain guidance on the tax DAC[3];
- Distortions caused by reinsurance; and
- Deferred tax liabilities (DTLs) and admissible deferred tax assets (DTAs).[4]

The importance of refining projected tax cash flows goes beyond simply meeting regulatory requirements. For example, many companies use some form of "economic value" measurement (such as embedded value) as a management tool. Generally, the purpose of that management tool could be to better understand the economic value of the enterprise and the period change in such value. Alternatively, the purpose could be to assess the incremental economic value effect on the enterprise of a particular initiative under consideration (a tax strategy, an acquisition, a new product, a new reinsurance treaty, etc.). In either case, the economic value measurement requires a projection of all material cash flows and other

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changes in free surplus. If the tax element of those projections is materially misstated, it calls into question the relative value of this management tool.

The balance of this article will take the issues noted above, and provide the necessary procedures for reflecting tax cash flows appropriately.

OPERATING LOSS DEDUCTIONS AND NET OPERATING LOSS CARRYBACKS AND CARRY-FORWARDS

A company that is a life insurance company under state law can be taxed as either a life insurance company or a non-life insurance company, depending on the nature of its reserves. The OLD and NOL carryforward/carryback rules differ.

The ordinary losses of a non-life insurance company (or a non-insurance company for that matter) are primarily discussed in Code section 172, and the related treasury regulations. Code section 172(b)(1)(A) allows non-life insurance companies to carry back an NOL to each of the two taxable years preceding the taxable year of loss, and to carry forward an NOL to each of the 20 years following the taxable year of loss.[5] A non-life insurance company may elect to forgo the carryback of an NOL, and thus apply the NOL only to the subsequent tax years.[6]

Life insurance company taxable income is determined under Subchapter L, Code sections 801 and following.

- Section 801(b) defines life insurance company taxable income as life insurance gross income reduced by life insurance deductions.
- Section 804 defines life insurance deductions as the general deductions provided for in section 805.
- Subsection 805(a)(5) of the list of general deductions references the operating loss deduction of section 810.
- Section 810(c) provides that the loss from operations is the excess of the life insurance deductions for any taxable year over the life insurance gross income for such taxable year.
- Section 810(b) provides for the carryback and carryover of the loss from operations.

A life insurance loss from operations is carried back three years and forward 15 years.7 This distinction from nonlife insurance companies (and non-insurance companies) is important and comes into prominence in life/non-life consolidated groups. The carryback and carryforward rules are mandatory, but do allow a taxpayer to elect to forgo a carryback.

Examples 1 and 2 below graphically illustrate the workings of the Life Company OLD carryback and carryforward rules.

In Life Company Example 1, the taxpayer has operating income as shown below.

In this example, the taxpayer is able to carry back the entire current year OLD from 2003 to years 2000, 2001 and 2002. This utilized the full amount of the OLD from 2003. In addition, the taxpayer can carry back the OLD from 2008 to 2005, 2006 and 2007. This carryback still leaves $20 of income in 2007. During the 2009 tax year, the taxpayer generates a current year OLD of $100. This can be carried back to 2007 to reduce taxable income to zero and this leaves $80 to carry forward to 2010 and offset that income. In the proper situation, the 2008 or 2009 OLD may have been carried back up to five years under the special election.[8]

Example 1: Life three-year carryback, 15-year carryforward (no capital gain/(loss) discussion)

Generation year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Operating income	100	70	100	(200)	100	50	70	100	(200)	(100)	100
Carryback from 2003	(100)	(70)	(30)	200	0	0	0	0	0	0	0
Carryback from 2008	0	0	0	0	0	(50)	(70)	(80)	200	0	0
Carryback from 2009 & Carryforward from 2009	0	0	0	0	0	0	0	(20)	0	100	(80)
Adjusted taxable income in year	0	0	70	0	100	0	0	0	0	0	20

Life Company Example 2 will illustrate the situation whereby the taxpayer elects to forgo the carryback of an OLD. In this example, the taxable income is the same as Example 1. However, the taxpayer will choose to forgo the carryback from 2009.

Example 2: Life three-year carryback, 15-year carryforward (forgo carryback)(no capital gain/(loss) discussion)											
Generation year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Operating income	100	70	100	(200)	100	50	70	100	(200)	(100)	100
Carryback from 2003	(100)	(70)	(30)	200	0	0	0	0	0	0	0
Carryback from 2008	0	0	0	0	0	(50)	(70)	(80)	200	0	0
Carryforward from 2009	0	0	0	0	0	0	0	0	0	100	(100)
Adjusted taxable income in year	0	0	70	0	100	0	0	20	0	0	0

As demonstrated in the chart above, by forgoing the carryback from 2009, the entire $100 may be carried forward from 2009 to 2010. The taxpayer may have chosen this election for a number of reasons, including audit or examination adjustments expected.

CAPITAL LOSS CARRYBACKS AND CARRYFORWARDS

Code section 1212 allows companies to carry capital losses back three years and forward five years. In addition to the use of capital losses to offset capital gains, life OLDs may offset life capital gains. This article will not discuss the use of nonlife NOLs to offset life capital gains or other consolidated return issues not specifically mentioned. Similarly to an NOL, capital losses are applied in the order generated. Thus, a loss carried forward from an earlier year must be applied before a loss can be carried back from a later year.

In Example 3, the capital gain and loss are generated on the first line. This example assumes no NOLs available to be used against capital gains.

Example 3: Life three-year carryback, five-year carryforward (no NOL discussion)											
Generation year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Capital gain/(loss)	50	0	0	(100)	100	(100)	0	0	50	0	0
Carryback and carryforward from 2003	(50)	0	0	100	(50)	0	0	0	0	0	0
Carryback and carryforward from 2005	0	0	0	0	(50)	100	0	0	(50)	0	0
Adjusted taxable income in year	0	0	0	0	0	0	0	0	0	0	0

Under Example 3, the taxpayer may carry back $50 in capital loss from 2003 to offset the 2000 capital gain. This left $50 remaining to be carried forward against the 2004 capital gain. Once the 2003 carryforward occurred, there remained $50 of capital gain in 2004. This amount was available from 2005 to be carried back. The remaining capital loss available was carried forward to 2008.

CONTINUED ON **PAGE 30**

While this article does not intend to discuss all nuances of ordinary and capital losses, a brief mention is due of IRC section 1212, which controls capital losses. Example 5 under the relevant treasury regulations[9] highlights an issue often not considered when companies work out analytical models. Under this example, a capital loss carried back to an earlier year to offset a capital gain will "bump" an ordinary loss carried forward to offset that gain. If the "bumped" OLD or NOL is close to expiring, there is an increased chance of OLD or NOL expiration, unused.

Consider a life insurance company taxpayer that has carried an OLD from 13 years ago to offset a capital gain. Two years later, the taxpayer generates capital losses. When that capital loss is generated, it offsets the capital gain, and the OLD previously used will be bumped. To the extent that there is no other ordinary income or capital gains, the NOL will expire unused in its 15th year.

COST BASIS OF INVESTED ASSETS FOR DETERMINING TAX DISPOSAL DATE

Generally companies project post-tax investment earnings via assumption of a pre-tax investment earnings rate, and multiplication of that rate by the complement of the marginal rate (e.g., 65 percent). This approach can sometimes be a gross oversimplification. The reasons are several, and can affect the tax cash flows in varying degrees depending on the fact pattern of the taxpayer. The situations that will distort this simplification include the following:

- When a bond is purchased in the secondary market at a market discount, such discount accrues for statutory purposes; however, the cost basis of the asset for tax generally remains the same until maturity or prior disposal. Meanwhile, statutory income will include the accrual of discount, causing statutory income to differ from taxable income because of this issue. In the present environment, for example, it is possible that many bonds available in the secondary market are trading below par value for credit quality reasons, and that this type of mismatch between statutory income and taxable income could become significant. If the yield curve rises in the future, this will additionally cause many higher-quality bonds to similarly trade at values below par value.

- Except to the extent of accrued market discount, disposal at other than the cost basis of the asset gives rise to capital gains and losses, not ordinary income. Capital losses can only be offset against capital gains, not against ordinary income. Thus, one must apply the appropriate character of the income or loss on assumed disposal decrements, be they default, prepayment, or actual maturity.

- To the extent the general account investment is in stock or tax-exempt bonds, the proration rules apply, significantly impacting the amount of investment income that is tax-free. For tax-exempt income, the policyholder share percentage (a function of the interest assumption on tax basis reserves) remains taxable, while the company share percentage (i.e., the complement of the policyholder share percentage) is at least partly tax-free to the company. For shareholder dividends from unaffiliated stock, 70 percent of the company share is tax-free.

It is recognized that actuarial projections generally do not model such asset characteristics. It would be interesting to see what the effect of such increased precision would be.

THE EFFECT OF CERTAIN GUIDANCE ON THE TAX DAC

The provision for tax-basis acquisition costs under Code section 848 (otherwise referred to as the "tax DAC") has often been projected in an inaccurate manner. Treasury Regulation Section 1.848-1 spells out certain rules that may merit careful reading, and could influence the accuracy of actuarial projections.

- The section 848 capitalization rate varies by type of business.
- There is no section 848 attribution for cancellable health insurance. However, there is a 20 percent reduction in the statutory unearned premium pursuant to Code section 807(e)(7). Further, to the extent there is a contract reserve, the better argument is that the contract reserve is an unearned premium for tax purposes, thus also subject to the 20 percent reduction from the statutory value.
- For qualified pension business there is no tax DAC. Thus in any projection, an assumption should be made as to the percent of business otherwise subject to the tax DAC but that is qualified pension.
- The DAC capitalization rate is very different between individual life insurance (7.7 percent), and that which is determined to be group life insurance (2.05 percent). The regulations define seven types of groups that would qualify as "group life" for these purposes.[10] Additionally, to be considered "group life insurance" for these pur-

poses, the underwriting must be in the form of "group underwriting."[11]

Second, in pricing and projecting the costs of policy benefit updates, care should be taken to avoid the deemed internal exchange rules in the regulations. Neglecting those rules may cause the DAC capitalization rate to apply to the total reserve on policy changes deemed to be internal exchanges.

Third, the tax DAC has certain special aspects:

- For smaller companies, where the tax DAC capitalization is under $15 million in a taxable year, at least part of the DAC capitalized may be amortized in five years, rather than 10.[12]
- It is possible that a company with a large amount of capitalization may have a very low level of expenses. In such case, the otherwise capitalizable amount may be capped by the "General Deductions" limitation, unless an election resulting otherwise is in place.

COMPLICATIONS CAUSED BY REINSURANCE

There are several aspects of reinsurance where statutory income and taxable income differ, for example:

- Various statutory rules will deny a statutory reserve credit, while for tax purposes the credit is required to be taken. Most notably, Appendix A-197 of the NAIC Accounting Practices and Procedures Manual provides many rules a company must satisfy in order to receive statutory reserve credit.
- Of course the tax DAC itself is a distortion from statutory income, since a statutory equivalent of this item does not exist. There are additional tax DAC provisions governing reinsurance that will further distort the incidence of the tax DAC. For example:
    - Under the treasury regulations, reinsurance ceded to a non-U.S. taxpayer (e.g., an alien reinsurer) will often result in a negative "net consideration," which cannot be utilized against tax DAC capitalization amounts arising from other sources. Negative capitalization caused by reinsurance with a non-U.S. taxpayer can at best be put into a "basket," against which future positive capitalization resulting from reinsurance with non-U.S. taxpayers can be taken.[13]
    - The net cash transferred constitutes section 848 "net considerations," as opposed to premiums by themselves. Thus claims, modco reserve adjustments, ceding allowances, etc., are all brought under this "net consideration" definition.
    - Finally, the ability to amortize all or a part of the tax DAC in five years instead of 10 years does not apply to reinsurance transactions.

DTLS AND ADMISSIBLE DTAS[14]

Aside from the fact that deferred taxes are a significant economic balance sheet item, the major statutory deferred tax issue for projection purposes is the effect of DTAs and DTLs on the statutory annual statement, i.e., the effect they have on statutory surplus and on free surplus. Since admitted DTAs for the life insurance industry as a whole have recently amounted to as much as 12 percent of capital and surplus, this is a significant item to include in projections of emerging statutory results. Actuaries often have not been taking DTAs and DTLs into account when performing projections. Yet the theoretical formulas for producing those balance sheet items, at least with respect to those arising from policyholder liabilities (i.e., tax DAC and reserve differences) are straightforward. When projecting the policy-related deferred tax item, it is generally reasonable to ignore DTLs, since they do not occur materially on policy-related issues. In an ideal world the policyholder-related "economic" DTA equals the following as of a given valuation date:

$$DTA = T^*[(SR - TR) + TDAC], \text{ where:}$$

T = Enacted tax rate
TR = Tax reserve
SR = Statutory reserve
TDAC = Tax DAC balance

In actual statutory practice, that amount is reduced substantially by certain regulatory "guardrails."[15] Moreover, the Company Action Level Risk Based Capital ("CALRBC") formula currently adds a component for the admitted DTA.

CONTINUED ON PAGE 32

Since admitted DTAs for the life insurance industry as a whole have recently amounted to as much as 12 percent of capital and surplus, this is a significant item to include in projections of emerging statutory results.

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The net admitted DTA can be approximated based on current company fact patterns, and projected as a percentage of some "base," and thus treated mathematically like a "negative reserve." The base can be the excess of statutory reserves over tax reserves, plus the tax DAC balance.

REGULATORY IMPLICATIONS

Under the Actuarial Opinion and Memorandum Model Regulation ("AOMR"), as it is currently worded, tax cash flows should be a part of the asset adequacy calculation. Thus, it is important for the tax cash flows to consider significant tax issues that veer away from a simplistic tax cash flow formula.

Further, under the AOMR, an economic, post-tax reserve is calculated, and then compared against a traditional formula reserve, which is, and should be, pre-tax. This is an inconsistent comparison. If a deferred tax asset exists with respect to those policyholder liabilities, then the proper comparison against the economic reserve should be the formula reserve minus the admitted DTA associated with those policies in question, as opposed to the formula reserve itself.

Insurers subject to Solvency II will soon be required to complete an Own Risk and Solvency Assessment (ORSA). A similar requirement may apply to insurers in the United States as a result of the NAIC's Solvency Modernization Initiative. More sophisticated modeling of tax considerations is recommended when companies perform dynamic capital adequacy and stress testing.

MANAGEMENT IMPLICATIONS AND CONCLUSION

For actuarial projections to serve as the management tools that they are intended to be, the persons charged with making those projections need to consider whether the projection is sufficiently sophisticated so that it does not miss major items. Moreover, when confronted with a possible opportunity or strategy, it is important to ask what the tax effect of that strategy will be, not just in the implementation year, but projected over the significant time horizon. This can be a difficult concept to communicate to company management, as taxes have a "mystique" in the eyes of many people.

Because tax expense is such a significant component of financial projections, the effort, both to increase the accuracy and to communicate its effect, should be very worthwhile.

Given the importance and complexity of tax considerations, it may also be an appropriate time for the Actuarial Standards Board to develop an Actuarial Standard of Practice to provide guidance to actuaries on tax-related matters.

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The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

END NOTES

1 Unless otherwise specified, all references are to the Internal Revenue Code of 1986, as modified, and the Treasury Regulations promulgated thereunder.

2 As will be discussed below, the Operating Loss Deduction is defined in Code section 810. Within the life insurance context, the generally known NOL of section 172 is defined as an Operating Loss Deduction.

3 Code section 848, "Capitalization of Certain Acquisition Expenses."

4 This brings up a related issue. It can be shown mathematically that there is a need to subtract policy-related admitted DTAs from the formula reserves, in order to compare consistently with the economic (post-tax) reserves that are produced under the asset adequacy testing requirement of the Actuarial Opinion and Memorandum Regulation.

5 IRC section 172(b)(1)(H) was added to allow a company to elect to carry back a non-life NOL from either 2008 or 2009 to any of the fifth, fourth or third taxable years prior to taxable year of loss.

6 *See* IRC section 172(b)(3).

7 Section 810 was modified by Public Law 111-92 to add subsection (b)(4), which allowed a taxpayer to elect to carry back a loss from operations generated in either 2008 or 2009, to tax years either four or five years prior.

8 *See* footnote 7.

9 Treasury Regulation 1.1212-1(a)(iv)(Example 5).

10 Treas. Reg. §1.848-1(h)(2)(ii)-(viii).

11 Treas. Reg. §1.848-1(h)(1) and (3).

12 Code §848(b)(4).

13 Treasury Reg. §1.848-2(f).

14 It is important to note that we are not speaking to the accuracy of the projected reversal patterns for admissible DTA calculation purposes in the statutory annual statements, Our comment here is on projection of the DTA's themselves as elements in projections of statutory net liabilities.

15 *See* Statement of Statutory Accounting Principles No. 101 ("SSAP 101").

PLR 201120011 HIGHLIGHTS THE NEED FOR SEPP GUIDANCE ON ANNUITIES

By Mark E. Griffin

Prior to PLR 201120011 (Feb. 11, 2011), it was widely believed that annuity payments that comply with the minimum distribution requirements under section 401(a)(9)[1] can satisfy the exceptions to the 10 percent penalty tax under section 72(q)(1) (for nonqualified annuity contracts) and section 72(t)(1) (for qualified retirement plans)[2] that apply for certain distributions which are made as part of a series of substantially equal periodic payments (or "SEPPs") under section 72(q)(2)(D) and section 72(t)(2)(A)(iv), respectively. However, in PLR 201120011 the Internal Revenue Service ("IRS") ruled that lifetime annuity payments which increase annually by a constant 1, 2, 3, or 4 percent and comply with section 401(a)(9) nevertheless fail to satisfy the "SEPP exception" to the penalty tax under section 72(q)(2)(D).[3] As explained below, this interpretation by the IRS effectively means that there is no published guidance on the circumstances in which any stream of annuity payments will constitute SEPPs. This position highlights the need for published guidance addressing the treatment of annuity payments as SEPPs. The treatment of annuity payments for penalty tax purposes is very important for nonqualified annuity contract owners who want to begin taking annuity payments prior to age 59½, individuals who want to receive annuity payments under their qualified retirement plans commencing prior to age 59½, and annuity issuers.

Sections 72(q)(1) and 72(t)(1) impose a 10 percent penalty tax on the taxable portion of an amount received under a nonqualified annuity contract and a qualified retirement plan, respectively, which is received before the taxpayer attains age 59½, unless an exception applies. Sections 72(q)(2)(D) and 72(t)(2)(A)(iv) provide virtually identical exceptions for distributions which are part of a series of SEPPs made not less frequently than annually for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and his designated beneficiary. It was widely believed that annuity payments which satisfy the section 401(a)(9) minimum distribution requirements would constitute SEPPs, and thus would not be subject to the 10 percent penalty tax that otherwise would apply prior to the taxpayer attaining age 59½.

This belief was based on Q&A-12 of Notice 89-25[4], which set forth three methods of determining SEPPs for purposes of section 72(t)(2)(A)(iv). One method, commonly referred to as the "required minimum distribution method," provides that payments under a qualified retirement plan will be treated as SEPPs "if the annual payment is determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9)."[5] This method was believed to be available for annuity payments even after Q&A-12 was modified by Rev. Rul. 2002-62.[6] The SEPP methods in Q&A-12, as modified by Rev. Rul. 2002-62, also apply for purposes of applying the section 72(q)(2)(D) SEPP exception for nonqualified annuity contracts.[7]

However, in PLR 201120011, the IRS stated that the guidance in Rev. Rul. 2002-62 "replaced" the guidance in Q&A-12. The IRS explained that:

> Rev. Rul. 2002-62 makes it clear that the required minimum distribution method involves an annual recalculation of the payments determined by dividing the *account balance* for that year by the number from the chosen life expectancy table for that year. Under this method, the annual payments may increase or decrease based on the *account balance* and the remaining life expectancy from the chosen table. (Emphasis added.)

Accordingly, the IRS determined that since the annuity payments in PLR 201120011 were not determined using the required minimum distribution method described in Rev. Rul. 2002-62 and Notice 89-25, the annuity payments did not constitute SEPPs, even though the payments complied with section 401(a)(9).

The import of this interpretation is that the required minimum distribution method in Q&A-12 is replaced by the required minimum distribution method in Rev. Rul. 2002-62 and is limited to contracts with an "account balance" (including deferred annuity contracts). Thus, this method does not apply to contracts under which annuity payments are being made

CONTINUED ON **PAGE 34**

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(or "payout" annuity contracts, which lack a conventional account balance). This effectively means that there is no published guidance addressing any circumstances in which annuity payments will constitute SEPPs. Hence, owners of nonqualified annuity contracts, individuals under qualified retirement plans, and annuity issuers are left without any published guidance on when annuity payments can be used to satisfy the SEPP exceptions to the 10 percent penalty tax under sections 72(q)(2)(D) and 72(t)(2)(A)(iv).

The insurance industry requested guidance on this issue.[8] On September 2, 2011, the Treasury Department and IRS released their joint 2011–2012 Priority Guidance Plan, which lists priority projects that they plan to work on actively during the period of July 2011 through June 2012. One of the priority projects listed is "Guidance on exceptions to additional tax under §72(t) on early distributions from retirement plans and IRAs."[9] Although this item does not specifically refer to annuities or the SEPP exception under section 72(t)(2)(A)(iv), it is hopeful that this guidance will cover the treatment of annuity payments as SEPPs.

In addition, it would be helpful for such guidance to provide comfort that an individual who satisfies a SEPP exception by taking distributions under one of the "individual account" methods described in Rev. Rul. 2002-62 can subsequently use annuity payments to satisfy the exception. This might occur, for example, if an individual begins taking SEPPs under a deferred annuity contract for a number of years and would like to continue taking SEPPs under a lifetime annuity option in the contract. The concern is that a replacement of SEPPs determined using one of the individual account methods in Rev. Rul. 2002-62 with annuity payments that satisfy the SEPP exception could be viewed as an impermissible modification of the series of payments. In this regard, sections 72(q)(3) and 72(t)(4) provide generally that if the applicable SEPP exception is used to avoid the 10 percent penalty tax, and the series of payments is modified (other than by reason of death or disability) before the close of the five-year period beginning on the date of the first SEPP or before the taxpayer attains age 59½, the previously avoided penalty tax is recaptured (with interest) in the year of the modification.

Applying the recapture rules where an individual alters a distribution method that satisfies the SEPP exception to a form that also satisfies the exception would appear to be contrary to congressional intent.

As the IRS recognized in PLR 201120011, annuity payments are determined differently than distributions under the methods described in Rev. Rul. 2002-62. Hopefully, published guidance will recognize that simply replacing SEPPs under Rev. Rul. 2002-62 with SEPPs in the form of annuity payments will not constitute a modification of the stream of payments which results in the recapture of the penalty tax. The legislative history describes the recapture rules under sections 72(q)(3) and 72(t)(4) as applying in cases in which a distribution method that satisfies the SEPP exception is changed to a form that does not qualify for the SEPP exception.[10] Applying the recapture rules where an individual alters a distribution method that satisfies the SEPP exception to a form that also satisfies the exception would appear to be contrary to congressional intent. If the recapture rules are triggered by switching from an individual account method of making payments under the SEPP exception to an annuity method of making payments under the SEPP exception, no individual who commences taking SEPPs under a method described in Rev. Rul. 2002-62 could ever annuitize their contract within five years or prior to age 59½ without incurring the penalty tax.

In short, the position of the IRS in PLR 201120011 highlights the need for published guidance addressing the application of the SEPP exceptions in sections 72(q)(2)(D) and 72(t)(2)(A)(iv) to annuity payments. The absence of such guidance has created a great deal of uncertainty for nonqualified annuity contract owners, qualified retirement plan participants and annuity issuers about (1) the circumstances in which annuity payments constitute SEPPs for purposes of these exceptions, and (2) whether distributions that satisfy a SEPP exception under an individual account method in Rev. Rul. 2002-62 can be replaced with annuity payments that satisfy the exception without incurring the penalty tax. Hopefully, the fact that the 2011–2012 Priority Guidance Plan includes an item on the exceptions to the 10 percent penalty tax under section 72(t) indicates the government's intention to issue guidance addressing these questions. ◀

END NOTES

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] A "qualified retirement plan" is defined for this purpose in section 4974(c) to include a plan under section 401(a), an annuity under section 403(a), a section 403(b) contract, an individual retirement account under section 408(a), and an individual retirement annuity under section 408(b).

[3] A private letter ruling cannot be cited as precedent. *See* section 6110(k)(3).

[4] 1989-1 C.B. 662, 666, modified by Rev. Rul. 2002-62, 2002-2 C.B. 710.

[5] *Id.* Q&A-12 provides that payments will also be treated as SEPPs if the amount to be distributed annually is determined (1) by amortizing the taxpayer's account balance over a number of years equal to the life expectancy of the account owner or the joint life and last survivor expectancy of the account owner and beneficiary at a reasonable interest rate (commonly referred to as the "amortization method"), or (2) by dividing the taxpayer's account balance by an annuity factor which is derived using a reasonable mortality table and using a reasonable interest rate (commonly referred to as the "annuitization method"). *Id.*

[6] Rev. Rul. 2002-62, 2002-2 C.B. 710, modifying Q&A-12 of Notice 89-25, 1989-1 C.B. 662, 666.

[7] Notice 2004-15, 2004-1 C.B. 526, 527; INFO 2000-0226. An information letter, like INFO 2000-0266, is a statement issued by the IRS National Office that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. *See* section 2.04 of Rev. Proc. 2002-1, 2002-1 C.B. 1. An information letter, like a private letter ruling, cannot be cited as precedent. *See* section 6110(k).

[8] Letter from Davis & Harman LLP written on behalf of the Committee of Annuity Insurers, to Internal Revenue Service (June 1, 2011) (on file with author); Letter from American Council of Life Insurers (ACLI), to Internal Revenue Service (June 1, 2011) (on file with Tax Analysts).

[9] U.S. Dep't of Treasury, 2011-2012 Guidance Priority Plan (2011), http://www.irs.gov/foia/article/0,,id=181687,00.html.

[10] H.R. Rep. No. 99-841, vol. II, at 400-403, 455-457 (1986) (Conf. Rep.); S. Rep. No. 99-313, at 567-568, 615 (1986); Staff of Jt. Comm. On Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, 659-660, 717-718 (1987).

IRS ISSUES GUIDANCE AND SEEKS COMMENTS ON LTC INSURANCE PRODUCT ISSUES

By Craig R. Springfield and Bryan W. Keene*

On Aug. 11, 2011, the Internal Revenue Service (IRS) released Notice 2011-68,[1] regarding the tax treatment of stand-alone and "combination" long-term care (LTC) insurance products. The Notice provides interim guidance on certain issues and requests public comment on others.

BACKGROUND

The Pension Protection Act of 2006 (PPA) amended the Internal Revenue Code (Code) to clarify and improve the tax treatment of LTC insurance products.[2] The amendments fall into two general categories—combination products and exchanges. A combination product is a life insurance or annuity contract that includes an LTC insurance feature.[3] The PPA amendments facilitate annuity-LTC combination products by generally extending to them the Code's rules for life insurance-LTC combination products.[4] The PPA amendments also address the tax treatment of charges against the cash value of the annuity or life insurance portion of a combination product to fund coverage under the qualified LTC insurance (QLTCI) portion, essentially treating them as non-taxable distributions from the annuity or life portion that reduce the owner's "investment in the contract" under section 72.[5] The PPA also amended section 1035 to allow tax-free exchanges of annuity and life insurance contracts for QLTCI contracts.

The PPA amendments facilitate annuity-LTC combination products by generally extending to them the Code's rules for life insurance-LTC combination products.

INTERIM GUIDANCE ON INVESTMENT IN THE CONTRACT

The Notice provides interim guidance under section 72 on how to determine the "investment in the contract" for the annuity portion of an annuity-LTC combination product. It states that all premiums paid for such a product are generally included in the investment in the contract for the annuity if (i) the premiums are credited to the contract's cash value (rather than directly to the LTC portion), and (ii) coverage under the LTC portion is funded through charges against the annuity's cash value. In this respect, the Notice appears to merely clarify that if QLTCI rider premiums are paid directly into the rider with after-tax monies, rather than through a charging mechanism under the annuity, then such premiums have no effect (positive or negative) on the investment in the contract for the annuity. Seemingly the same rule also would apply in the case of life-LTC combination products.

In that regard, the Notice observes that, other than the PPA amendments regarding how LTC insurance charges affect investment in the contract (summarized above), the PPA did not amend the definition of investment in the contract under section 72. Consistently with this observation, the Notice also states that a waiver of premiums under an annuity-LTC combination product, such as upon disability or chronic illness, "should be accounted for in the same manner as a waiver of premiums under other contracts for which 'investment in the contract' is determined under § 72(c)(1) or 72(e)(6)."[6]

INTERIM GUIDANCE ON EXCHANGES

The Notice also provides interim guidance on the treatment under section 1035 of exchanges of an annuity or life insurance contract for a QLTCI contract. First, it clarifies that a partial exchange of an existing deferred annuity for a QLTCI contract can qualify for tax-free treatment under section 1035. This conclusion is consistent with earlier guidance and a court decision in which an exchange of a portion (but not all) of a deferred annuity for another deferred annuity was treated as tax-free under section 1035.[7]

Second, the Notice states that the "adjusted basis" of a QLTCI contract received in a tax-free exchange generally carries over from the life insurance, endowment, annuity or QLTCI contract being exchanged. In this regard, the Notice observes that although the Code prohibits a QLTCI contract from providing a cash value, it does permit a refund of premiums upon complete surrender or cancellation of the contract, and provides generally that such a refund is includible in gross income to the extent that any deduction or exclusion was allowable with respect to the premiums.[8] Thus, the

Notice's statements regarding the adjusted basis of a QLTCI contract purchased in a tax-free exchange may mean that any cancellation or surrender proceeds received under the contract are taxable to the extent the exchange involved the movement of tax-deferred inside buildup from an annuity, life insurance, endowment contract or QLTCI contract to the QLTCI contract received in the exchange.

REQUEST FOR PUBLIC COMMENT

The Notice requests public comment on several questions "to assist in the development of further guidance" on combination products. Comments were due by Nov. 9, 2011. The topics on which the Notice seeks comments are:

(1) Issues that arise when an annuity-LTC combination product is annuitized, including the effect on the owner's rights, how the LTC insurance charges should be treated after the annuity starting date, and how the exclusion ratio should be calculated under section 72(b).

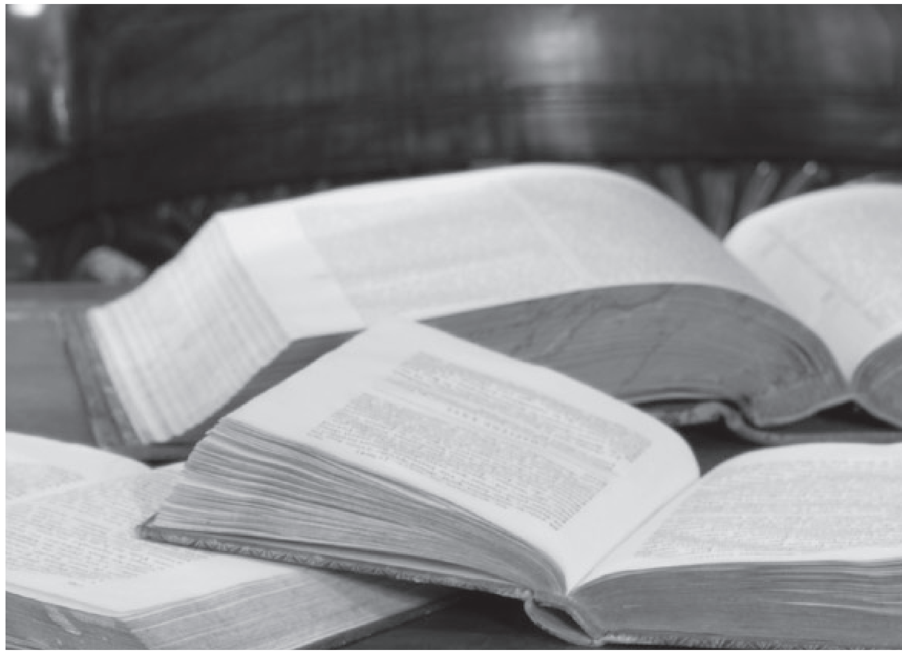
(2) Issues involving how a "risk shifting" analysis should apply in determining whether the LTC portion of a combination product is an "insurance" contract for purposes of section 7702B, including how LTC benefit payments that reduce the annuity contract's cash value should be taken into account in such an analysis and whether there are common features or contract designs that would lend themselves to published guidance on the risk shifting issue.

(3) Whether guidance is needed on partial exchanges of some or all of the payments under an immediate annuity for a QLTCI contract, including how to effect such an exchange, how such a partial exchange is treated under section 1035, and how the adjusted basis and investment in the contract are determined for the contracts involved in the partial exchange.

(4) Whether any changes are needed to existing guidance, including publications, forms, and instructions, on information reporting and record keeping with respect to QLTCI contracts and combination products.

ADDITIONAL ISSUES

Although the Notice provides interim guidance on some issues and seeks public comments on others, it is silent on a few questions that have arisen in connection with combination products. Perhaps most conspicuously, the Notice does not address or seek input on the question of how tax-free benefits received under the QLTCI portion of an annuity-LTC combination product affect the owner's investment in the contract for the annuity portion of the product.



In that regard, in most products that combine a deferred annuity with a QLTCI feature, at least some of the benefits paid under the QLTCI portion have the effect of reducing the cash value of the deferred annuity portion.[9] In a 2009 private letter ruling,[10] the IRS concluded that LTC insurance benefit payments "will reduce the 'investment in the contract'" of the annuity, but the ruling did not elaborate on how. This conclusion in the ruling has been questioned,[11] and the life insurance industry has advocated for a different result. As a result, it is expected that the industry's response to the Notice will include comments on this issue. In that respect, the IRS has indicated informally that it is willing to consider any comments that taxpayers may wish to file in response to the Notice, even on issues that the Notice does not specifically identify.

CONCLUSION

The Notice provides interim guidance on a narrow set of issues that are relatively devoid of controversy. In that regard, IRS and Treasury representatives have indicated informally

CONTINUED ON PAGE 38

that the Notice was intended as a first step toward addressing questions on combination products and to seek input on other questions that may be more difficult from a technical or tax policy perspective. As a result, the most interesting guidance in this area is likely still to come.

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END NOTES

* The authors would like to thank Josh Landsman, an associate at Davis & Harman LLP, for his contributions to this article.

[1] 2011-36 I.R.B. 205.

[2] Pub. L. No. 109-280 § 844 (2006). For a detailed discussion of the PPA amendments regarding LTC insurance products, *see* Craig R. Springfield, Bryan W. Keene and Frederic J. Gelfond, *New Rules and Opportunities for Long-Term Care Insurance Combination Products*, Taxing Times, May 2007, at 20.

[3] *See* section 7702B(e) (referring to LTC insurance coverage "provided by a rider on or as part of a life insurance contract or annuity contract"). Unless otherwise indicated, each reference herein to a "section" is to a section of the Internal Revenue Code of 1986, as amended.

[4] *See* section 844(c) of the PPA (amending Code section 7702B(e) to refer to annuity contracts).

[5] *See* section 72(e)(11). QLTCI rider charges cannot reduce the investment in the contract below zero. *Id.*

[6] The Notice cites Estate of Wong Wing Non v. Commissioner, 18 T.C. 205 (1952), for the proposition that waived premiums are not treated as constructively received as disability benefits, and thus are not included as part of the premiums paid for an endowment life insurance contract. *Compare* Rev. Rul. 55-349, 1955-1 C.B. 232.

[7] *See* Rev. Proc. 2011-38, 2011-30 I.R.B. 66; Rev. Rul. 2003-76, 2003-2 C.B. 355; Conway v. Comm'r, 111 T.C. 350 (1998), acq., 1992-2 C.B. xvi. For a discussion of Rev. Proc. 2011-38 and the treatment of partial exchanges of annuities more generally, see Bryan W. Keene and John T. Adney, *Partial Exchange Guidance Keeps Improving*, Taxing Times, Feb. 2012, at 1. *http://www.soa.org/news-and-publications/newsletters/taxation/tax-detail.aspx.*

[8] *See* section 7702B(b)(1)(D) (prohibiting cash values under QLTCI contracts); section 7702B(b)(1)(E) and (2)(C) (regarding refunds of premiums under QLTCI contracts).

[9] *See, e.g.*, PLR 201105001 (Oct. 22, 2010); PLR 200919011 (Feb. 2, 2009).

[10] PLR 200919011 (Feb. 2, 2009).

[11] *See, e.g.*, Craig R. Springfield and Mark E. Griffin, *IRS Private Letter Rulings on "Combination" Insurance Products,* Taxing Times, Sept. 2009, at 56.

ACLI UPDATE COLUMN REGULATORY DEVELOPMENTS

By Mandana Parsazad, Pete Bautz and Walter Welsh

ACLI and its many members have been engaged with regulators on a host of issues as they have considered new guidance. The latter part of 2011 witnessed Treasury and Internal Revenue Service (IRS) release of guidance on (1) partial exchanges and partial annuitization of non-qualified annuity contracts, (2) life insurance and annuity contracts with long-term care (LTC) insurance features, and (3) exchanges of life insurance, annuity and LTC contracts for LTC insurance coverage. ACLI and its members also continued discussions with Treasury and IRS about the applicability of the Foreign Account Tax Compliance Act[1] ("FATCA") to Life Insurance Companies and Products in response to Notices 2011-34 and 2011-53. We elaborate on these efforts below.

PARTIAL EXCHANGES OF NON-QUALIFIED DEFERRED ANNUITY CONTRACTS

In June 2011, Treasury and IRS released new guidance on the federal tax treatment of partial exchanges of non-qualified deferred annuity contracts. Revenue Procedure 2011-38 supersedes Rev. Proc. 2008-24, prior guidance on this issue, and modifies many aspects of it.

Rev. Proc. 2008-24 treated the exchange of a portion of an annuity contract for a new contract as a tax-free exchange under section 1035 provided no amounts were withdrawn from, or received in surrender of, either of the contracts involved in the exchange within 12 months from the date of the exchange. Taxpayers demonstrating that one of the conditions described in section 72(q)(2)(A)-(C), (E), (F), (G), (H) or (J) "occurred between" the exchange date and withdrawal or surrender were excepted from the 12-month waiting requirement. Any subsequent withdrawal or surrender that did not meet these requirements voided the initial section 1035 exchange and made the entire transaction a taxable distribution. ACLI, in conjunction with the Committee of Annuity Insurers, sought clarification on this point and urged the government to consider conditions that would align partial exchanges with partial annuitizations, a position that was endorsed by legislators in the Small Business Jobs Act of 2010.

In Rev. Proc. 2011-38, the Treasury and IRS acknowledged some concerns caused by the "occurred between" requirement for the section 72(q)(2) exceptions, addressed the enactment of the Small Business Jobs Act of 2010 (which amended section 72 to clarify the rules for direct partial annuitization transactions), and modified prior guidance. For additional details on the guidance, please see *Partial Exchange Guidance Keeps Improving* in this issue of *Taxing Times*.

LIFE INSURANCE AND ANNUITY CONTRACTS COMBINED WITH LONG-TERM CARE INSURANCE

In response to ACLI's continued request for guidance, in August 2011, Treasury and IRS released Notice 2011-68[2] with interim guidance on annuity and life insurance contracts with LTC riders. The Notice specifically responded to the industry's request for guidance on the tax treatment of basic policy transactions and also provided an opportunity for additional comments on issues identified by ACLI. For further discussion on these topics, we direct readers to the article *IRS Issues Guidance and Seeks Comments on LTC Insurance Product Issues* in this issue of *Taxing Times*.

In November 2011, ACLI submitted its comment letter in response to Notice 2011-68. Our comments identified issues of high priority for the industry and underscored the need for guidance on combination contracts as well as exchanges of life, annuity and LTC contracts for LTC coverage. We stressed the need for guidance on the effect of the payment of LTC insurance benefits on the investment in the contract so companies can develop and market new combination products. We also highlighted the need for guidance on exchange issues so own-

In response to ACLI's continued request for guidance, in August 2011, Treasury and IRS released Notice 2011-68[2] with interim guidance on annuity and life insurance contracts with LTC riders.

CONTINUED ON PAGE 40

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ers of life insurance and annuity contracts would be able to understand the tax consequences of exchanging life, annuity or LTC contracts for LTC insurance protection. Treasury and IRS have listed guidance on annuity/LTC combination contracts and exchanges of annuity contracts for LTC contracts on their 2011–2012 Priority Guidance Plan.

NOTICE 2011-34—APPLICABILITY OF FOREIGN ACCOUNTS TAX COMPLIANCE ACT ("FATCA") TO LIFE INSURANCE COMPANIES AND PRODUCTS

FATCA, which requires increased disclosure of offshore accounts in order to improve tax compliance, was enacted as part of the Hiring Incentives to Restore Employment Act ("HIRE" Act) in March 2010. The provisions of FATCA impose a 30 percent withholding tax on payments to "foreign financial institutions" that do not comply with information reporting requirements with respect to financial accounts maintained by U.S. taxpayers in their institutions. FATCA is effective for payments made after Dec. 31, 2012.

In April 2011, Treasury and IRS issued a second Notice on FATCA: Notice 2011-34, a Supplemental Notice to Notice 2010-60,[3] that provided further guidance and requested additional comments on certain issues under chapter 4 subtitle A of the Code. Additional commentary on Notice 2011-34 is provided in *Notice 2011-53 Provides FATCA Transitional Relief,* included in this issue of *Taxing Times.* This Notice specifically asked whether insurance companies should undertake procedures similar to those outlined for private banking accounts with respect to holders of pre-existing individual accounts, including private placement life insurance ("PPLI"). ACLI submitted comments in response to Notice 2011-34 in July 2011, which addressed procedures outlined in the Notice for identification of U.S. accounts among pre-existing accounts. In particular, the letter suggested that any identification and reporting required for pre-existing accounts in Step 5 of the Notice be limited for life insurance products to so-called "PPLI products," with all of the following characteristics:

- Cash values exceeding $1,000,000;
- Enable policyholders to direct how the assets will be invested, and such direction is not limited to choosing from predefined funds offered to the public;
- Initial investment is through lump-sum premiums (later top-up premiums may be possible) of at least $1,000,000;
- Assets belonging to the policy are managed in a bank or custodial segregated account for each separate policy (as distinguished from other standard insurance products where assets are pooled with other assets of the insurer or assets of policyholders owning similar policies are commingled in separate or segregated accounts held for their benefit by the insurer);
- Allow policyholders to contribute assets other than cash to the segregated accounts; and
- Are not offered to the general public, *i.e.*, are sold only through private offerings.

We recommended a one-time electronic search of such policies for U.S. indicia meeting the criteria outlined above. We requested that all other pre-existing accounts that do not meet the criteria outlined above be exempted from chapter 4.

Our letter also included some preliminary observations in response to the timeline for implementation set forth in Notice 2011-53. In Notice 2011-53, Treasury and IRS acknowledged the legal and practical difficulties in implementing chapter 4. We requested that the timeline for life insurers be extended to allow for an opportunity to review and comment on detailed guidance specific to life insurance companies and products similar to those provided to financial institutions in Notices 2010-60, 2011-34 and 2011-53. We have also communicated general concerns that life insurers share with other corporations as payors and potential withholding agents, especially as parties to financial instruments and arrangements where the identity of the counterparty is unknown or changing.

Treasury and IRS have listed guidance and regulations to implement chapter 4 as an item on their 2011–2012 Priority Guidance Plan.

END NOTES

1 Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the "HIRE") Act.
2 I.R.B. 2011-36 (Sept. 6, 2011).
3 *See also* Frederic J. Gelfond and Mary M. Gillmarten, FATCA and Insurance: Fundamental Questions Remain Unanswered as Compliance Deadline Approaches, Taxing Times, Vol. 7 Issue 3 (Sept. 2011).

T3: TAXING TIMES TIDBITS

FAVORABLE TAX TREATMENT OF ADVANCE INTEREST ON POLICY LOANS CONFIRMED IN IRS PUBLISHED GUIDANCE

By Peter H. Winslow

Many life insurance contracts provide for advance payment of interest on policy loans. Typically, the principal amount of the policy loan is increased by interest for the period from the date of the loan to the anniversary date of the policy, or the loan proceeds distributed to the policyholder are reduced for the interest due in advance. Thereafter, interest is due in advance on each policy anniversary date until the loan is repaid and any unpaid interest is added to the principal amount of the policy loan.

Under paragraph 7 of Statement of Statutory Accounting Principle 49 (SSAP 49), interest income on policy loans is reported for statutory accounting purposes as earned, consistent with Statement of Statutory Accounting Principle 34 (SSAP 34) Investment Income Due and Accrued. Advance interest received before it is earned is recorded as a liability in accordance with Statement of Statutory Accounting Principle 5R (SSAP 5R) Liabilities, Contingencies and Impairment of Assets.

Historically, advance interest on policy loans created a tax problem for life insurance companies. The Internal Revenue Service (IRS) adopted the position that advance interest was properly accrued into income even though it had not yet been earned.[1] The Tax Court disagreed with the IRS's ruling in circumstances where the interest was added to the policy loan balance and not actually prepaid.[2] The court reasoned that the interest should be includible when earned because, absent an actual interest payment, interest does not accrue until it is earned. The Tax Court's conclusion, however, was rejected by several circuit courts.[3]

Regulations relating to original issue discount (OID) issued in 1994 changed all this. Several life insurance companies submitted change-in-method-of-accounting requests to the IRS which made the following argument.

(1) Treas. Reg. § 1.446-2(c) provides that the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to the regulations under I.R.C. §§ 1272 and 1275 for the accrual of original issue discount.

(2) Under Treas. Reg. § 1.1273-1(a), OID exists to the extent the stated redemption price at maturity on a debt instrument exceeds the issue price of the instrument. That is, OID is the excess of what a borrower is obligated to repay when the loan becomes due over the amount borrowed.

(3) Under regulations issued in 1994, a payment from the borrower to the lender at the outset of a debt is treated as a reduction of the issue price.[4] Therefore, a policy loan providing for interest in advance creates OID.

(4) While I.R.C. § 1272(c)(2) exempts life insurance companies from I.R.C. § 1272 OID accrual, I.R.C. § 811(b) provides that life insurance gross income shall be adjusted to reflect the appropriate accrual of discount attributable to the taxable year on evidences of indebtedness held by a life insurance company.

(5) Therefore, the companies argued, despite Rev. Rul. 58-225 and the adverse case law, the 1994 OID regulations and I.R.C. § 811(b) require that life insurance companies account for advance interest on policy loans in a manner similar to the accrual of OID.

(6) Under I.R.C. § 811(b), the method of accrual of OID can be in accordance with the statutory method—as it is earned.

The IRS granted the companies' requests for changes in method of accounting following this reasoning. Now, almost

CONTINUED ON **PAGE 42**

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17 years later, the IRS has finally made public its ruling position on advance interest on policy loans. In Rev. Rul. 2011-15[5] the IRS stated that Rev. Rul. 58-225 is obsolete in light of the 1994 OID regulations. The revenue ruling is useful to avoid confusion and to make sure that companies do not follow prior guidance and case law that has long been overruled by regulations.

END NOTES

1 Rev. Rul. 58-225, 1958-1 C.B. 258.
2 *Bankers Union Life Ins. Co. v. Comm'r*, 62 T.C. 661 (1974).
3 *See Northern Life Ins. Co. v. U.S.*, 685 F. 2d 277 (9th Cir. 1982), and cases cited therein.
4 Treas. Reg. § 1.1273-2(g)(2)(i).
5 2011-30 I.R.B. 57 (July 25, 2011).

CREDIT DEFAULT SWAPS: CRISIS RESOLVED

By Kevin T. Leftwich

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Credit default swaps caused a lot of problems. Some big—they played a significant role in the greatest economic meltdown our country has seen in decades. Some small—they caused tax practitioner headaches figuring out how they should be treated for tax purposes.[1] Good news! One of these problems has been solved.

A credit default swap, in its most basic form, is an agreement that provides for a payment from one party to another party in the event of a loan default or some other specified trigger. It is often thought of as something akin to an insurance policy against default. Credit default swaps are used to hedge risk or, when purchased by an entity not holding the underlying reference loan (a "naked" credit default swap), as a form of speculation. The proliferation of credit default swaps helped magnify the losses caused by the housing collapse, validating, in the view of some observers, Warren Buffett's previous characterization of credit derivatives as financial weapons of mass destruction. While some argue whether enough has been done to regulate the use of credit default swaps following the collapse, we can all rest assured that we now know how the Internal Revenue Service (IRS) believes holders of the swaps should treat them for tax purposes.

The IRS and Treasury released proposed regulations on Sept. 15, 2011, that address a number of issues regarding the taxation of financial products and derivatives.[2] Among other issues addressed, the proposed regulations provide guidance regarding the proper characterization of credit default swaps. The regulations update the definition of notional principal contracts to now include credit default swaps.[3] As such, they will be taxed under the notional principal contract rules set forth in Treas. Reg. § 1.446-3, resulting in the income or deduction from the contract being equal to the net payments made or received in the taxable year.[4]

Classifying credit default swaps as notional principal contracts eliminates taxpayer uncertainty but does not necessarily provide the answer everyone was hoping for. Some taxpayers had taken the position that credit default swaps represented contingent put options in which the purchaser has the option to settle for cash value following the occurrence of the triggering event.[5] As a result, these taxpayers excluded the premiums paid or received from taxable income until the credit default swaps were terminated or expired.[6] Additionally, prior to the issuance of the proposed regulations, some groups advocated for credit default swaps to be considered a form of insurance in situations where the holder was exposed to the underlying credit risk.[7] The New York State Insurance Department temporarily supported this position when it announced that it intended to treat credit default swaps as insurance contracts when the purchaser also held the reference loan.[8] Thankfully, the proposed regulations have a prospective effective date and should not affect the validity of accounting methods taken before their issuance.[9]

The credit default swap clarification was just one of many issues addressed by the regulations. In addition to pronouncing that credit default swaps qualify as notional principal contracts, the proposed regulations provide that notional principal contracts are excluded from the definition of a "section 1256 contract" under I.R.C. § 1256(b)(2)(B).[10] Section 1256 contracts, defined as "any regulated futures contract, any foreign currency contract, any nonequity option, any dealer equity option, and any dealer securities futures contract,"[11] are required to be marked-to-market at the end of each taxable year, and any gain or loss is characterized as 40 percent short-term capital gain and 60 percent long-term capital gain.[12] Section 1256(b)(2)(B) provides an exclusion from the definition of section 1256 contracts for "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement." The exclusion was added at the end of the Dodd-Frank Act in response to concerns that the requirements placed on certain over-the-counter traded derivatives by the Act would result in them being swept into the definition of "regulated futures contracts."[13] To clarify the scope of the exclusion, the proposed regulations explain that Congress's decision to incorporate language in I.R.C. § 1256(b)(2)(B) that parallels language used in the definition of a notional principal contract in Treas. Reg. § 1.446-3(c) indicates an attempt to harmonize the category of swaps excluded from the definition of section 1256 contracts with swaps that qualify as notional principal contracts. Excluding notional principal contracts from section 1256 treatment eliminates taxpayer uncertainty (a good thing) and ensures that taxpayers will not be subjected to the consequences imposed by section 1256.

The section 1256 exception is critical for insurance companies that are using swaps to hedge capital assets that do not qualify for tax hedging treatment under section 1221(a)(7).[14] A capital asset hedge through a section 1256 contract results in insurance companies' gain/loss from contracts managing interest rate risk being capital instead of ordinary. Limitations on the ability to offset ordinary income and shorter carry-forward provisions reduce the utility of such capital losses. Additionally, the mark-to-market treatment imposed by section 1256 could result in a timing mismatch between the tax treatment of the hedge contract and the economic gain or loss on the hedged capital asset. Given the important role that derivatives play in managing risk in insurance companies' core business operations, these potential character and timing mismatches could have resulted in significant tax planning issues if a notional principal contract were treated as a section 1256 contract.[15] For these reasons, the Dodd-Frank exception and the proposed regulations' confirmation that notional principal contracts are excluded from the definition of section 1256 contracts should be welcome news to insurance company taxpayers.

END NOTES

1. *See* Notice 2004-52, 2004-2 C.B. 168.
2. REG-111283-11.
3. Prop. Reg. §1.446-3(c)(1)(iii).
4. Treas. Reg. § 1.446-3(d).
5. *See* Notice 2004-52, 2004-2 C.B. 168.
6. *See* Rev. Rul. 78-182, 1978-1 C.B. 265; I.R.C. § 1234.
7. *See* Notice 2004-52, 2004-2 C.B. 168.
8. New York State Insurance Department, Circular Letter No. 19 (Sept. 22, 2008).
9. Prop. Reg. § 1.446-3(j). *See* Amy S. Elliot and Lee A. Sheppard, *Proposed Derivatives Regulations Shouldn't Change Position on Bullet Swaps*, Highlights & Documents, Oct. 31, 2011, at 7903, for additional discussion on the prospective application of the proposed regulations.
10. Prop. Reg. § 1.1256(b)-1(a).
11. I.R.C. § 1256(b)(1).
12. I.R.C. § 1256(a).
13. Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 (2010), § 1601. *See* John R. Newton, *Deactivating the Weapons of Mass Volatility: The Dodd-Frank Act, Section 1256 and the Taxation of Derivatives*, Taxing Times, May 2011, at 33, for a detailed discussion of the issues presented by the Dodd-Frank Act's derivative reform provisions and the necessity for the I.R.C. § 1256(b)(2)(B) exclusion.

END NOTES CONT.

14. *See* Comments of Alan Fu of Prudential Financial Inc. (Apr. 23, 2010), Doc 2010-9908, 2010 TNT 86-22. Mr. Fu's letter was written to the Treasury Department explaining the problems that would result for insurance companies if certain provisions in Dodd-Frank resulted in additional derivative contracts being forced into section 1256 treatment.
15. *See* Newton, *supra* note 13, at 35, for more detailed discussion of the issues section 1256 contract treatment creates for corporate taxpayers.

IRS CONFIRMS APPLICATION OF SRLY CUMULATIVE REGISTER CONCEPT TO DUAL CONSOLIDATED LOSSES

By Lori J. Jones

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Recent informal Internal Revenue Service (IRS) guidance confirms that the cumulative separate return limitation year (SRLY) register concept applies in determining whether a dual consolidated loss (DCL) can be utilized within a consolidated group. Many U.S. insurance groups own one or more offshore insurance companies to which the DCL limitations apply by reason of a section 953(d) election to treat the foreign insurer as a domestic insurer for U.S. tax purposes. Accordingly, the recent informal guidance facilitates utilization of a section 953(d) company's DCL in a U.S. consolidated income tax return.

The application of the cumulative register allows a DCL subject to the domestic use limitation rule, and in turn subject to the SRLY limitations (in Treas. Reg. § 1.1503(d)-4(c)(3)), to be utilized to the extent that the member or unit that incurred the DCL made a positive cumulative contribution to taxable income of the consolidated group in all prior consolidated return years. Prior to the IRS adoption of the SRLY cumulative register under the general consolidated return regulations, the SRLY limitation was computed on a year-by-year approach. In that case, a SRLY net operating loss (NOL) could not be utilized in a current year if the member that generated the SRLY NOL had no taxable income in the current year, even if the member had made a cumulative contribution to taxable income while a member of the consolidated group. IRS personnel had previously indicated orally that the cumulative approach also would apply to DCLs, but this is the first published guidance confirming the application.[1]

CONTINUED ON **PAGE 44**

Confirmation of the application of the cumulative SRLY register to DCLs is beneficial to section 953(d) corporations because they are unable to take advantage of certain exceptions under Treas. Reg. § 1.1503(d)-6 to the domestic use limitation rule on a DCL; e.g., under section 953(d)(3), the section 1503(d)(2)(B) exceptions to DCL treatment where there is no foreign use do not apply.[2] A section 953(d) election can be made for a foreign insurance company to be treated as a domestic corporation if: (i) the foreign corporation is a controlled foreign corporation (as defined in section 953(d)(1)(A)), (ii) such foreign corporation would qualify as an insurance company (life or property and casualty) for federal tax purposes, (iii) such foreign corporation meets the requirements imposed by the Secretary, and (iv) such corporation makes an election and waives all benefits to such corporation granted by the United States under any treaty. Rev. Proc. 2003-47, 2003-2 C.B. 55, provides guidance for making this election. Thus, the ability to utilize the DCL within the consolidated group using the cumulative SRLY register is important because of the section 953(d) corporation's otherwise limited ability to utilize the DCLs within a consolidated return.

BACKGROUND

Section 1503(d) provides that a DCL shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. A DCL is an NOL of a dual resident corporation or the net loss attributable to a separate unit under the relevant regulations.[3] The purpose of the domestic use limitation is to prevent a loss generated by a dual resident corporation, which reduces foreign income tax, to reduce U.S. taxable income a second time. Although that is the purpose, the regulations provide a mechanical rule that has much broader application and has been upheld by courts.[4] In the insurance context, a DCL arises frequently for foreign captive insurance companies (e.g., Triple X reinsurers) that elect under section 953(d) to be taxed as a domestic corporation. Specifically, Treas. Reg. § 1.1503(d)-4(c)(3) provides that a DCL is treated as a loss incurred in a separate return year, and subject to all of the limitations of Treas. Reg. § 1.1502-21(c) (the SRLY provisions), with certain modifications, when the general limitation on the domestic use of a DCL applies.[5] This brings into play the SRLY cumulative register concept contained in Treas. Reg. § 1.1502-21(c)(1)(i).

SUMMARY OF AM 2011-002 (AUG. 1, 2011)

In AM 2011-002 (Memorandum), the U.S. parent of a consolidated group owned the stock of USS, a domestic corporation, which owned 100 percent of the interests in FEX, an entity organized under the laws of Country X, and subject to Country X tax on its worldwide income, but disregarded as a separate entity for U.S. tax purposes.[6] The FEX Separate Unit included both USS's interest in FEX as well as USS's indirect interest in its share of the business operations conducted by FEX. Because no domestic use election under Treas. Reg. § 1.1503(d)-6(d) through (j) was made and no other exception in Treas. Reg. § 1.1503(d)-6 applied, any DCL generated by FEX (a dual resident corporation) was subject to the domestic use limitation rule on its use in the U.S. parent's consolidated return. As stated in the Memorandum, the issue was "whether the application of the SRLY rules to a DCL subject to the domestic use limitation rule may, in certain cases, allow the DCL to be used to offset income of a domestic affiliate in the year the DCL is incurred."

In the Memorandum, the IRS concluded that the DCL attributable to the FEX Separate Unit could be utilized in the U.S. parent's consolidated return *in Year 2* as long as the separate unit had contributed to the cumulative consolidated taxable income of the group during consolidated return years. The IRS noted that, if the FEX Separate Unit had \$120x of income in Year 1, the consolidated group may utilize a DCL generated by the FEX Separate Unit in Year 2 in the amount of \$100x. By contrast, if the FEX Separate Unit generated only \$60x of income in Year 1, only \$60x of the \$100x DCL could be utilized in Year 2. There was some potential uncertainty on this issue because Treas. Reg. § 1.1503(d)-4 was finalized in 2007 with no explicit reference to the cumulative register concept despite the fact that the IRS had previously adopted the cumulative register concept under the general SRLY regulations in 1999 and could have been explicit on the issue when the DCL regulations were finalized in 2007.

The IRS had several grounds for its conclusion that the cumulative SRLY register approach applies to DCLs. First, the IRS concluded that, because the DCL regulations fully incorporate the SRLY limitations (except for the modifications contained in Treas. Reg. § 1.1503(d)-4(c)(3)), the cumulative register concept applies to DCLs that are subject to the domestic use limitation. Footnote 13 in the Memorandum also lists several provisions in the DCL regulations which the IRS views as implicitly referencing the cumulative register concept.[7] Second, the IRS acknowledged that, unlike a DCL, a SRLY NOL is not generated within a consolidated return year. However, it then referenced the last sentence of Treas. Reg. § 1.1503(d)-4(c)(2) dealing with separate units which states that the DCL may be carried over or back for use in other taxable years as a separate NOL carryover or carryback of the separate unit arising in the year incurred. The IRS relied on this principle as additional support for application of the SRLY limitation to the DCL as a SRLY NOL carryover or carryback even if the DCL is utilized in the year it is generated. Third, the IRS analogized the DCL to a built-in loss subject to a SRLY limitation under Treas. Reg. § 1.1502-15(a), which can be incurred within a consolidated return year, and utilized subject to a SRLY limitation. Finally, the IRS concluded that the policy behind the DCL limitations is not violated by the use of the DCL using the SRLY cumulative register concept because it concluded that the FEX Separate Unit's DCL was in effect only offsetting its "own" income.

In summary, the IRS provided ample support for its reasonable conclusion, although commentators have requested that the guidance be adopted in the form of regulations or other more formal guidance.[8] The guidance is particularly welcome since no real policy purpose would be served by barring the use of the DCL in a consolidated return year when the company had already contributed to consolidated income in a previous year. Moreover, the Memorandum's support of the cumulative SRLY register concept to DCLs is particularly helpful in the context of a section 953(d) corporation, which has no ability to apply an exception to the domestic use limitation. ◀

END NOTES

1. At the ABA Section of Taxation meeting in September 2010, David Bailey, Branch 4 senior technician reviewer, IRS Office of Associate Chief Counsel (International), stated that a taxpayer should be able to utilize a current-year DCL to offset consolidated taxable income—at least to the extent of the cumulative register of the separate unit that had the loss. Amy S. Elliott, *SRLY Rules Allow Favorable Usage of Dual Consolidated Losses, IRS Official Says*, 2010 TNT 186-3, Sept. 27, 2010. *See also* Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* § 41.03[3][c] n.108.45 (2d edition 2008).
2. Treas. Reg. § 1.1503(d)-6(a)(3) provides that the exceptions contained in -6 do not apply to losses of a foreign insurance company that is a dual resident corporation under Treas. Reg. § 1.1503(d)-1(b)(2)(ii), i.e., foreign insurance company treated as a domestic corporation pursuant to section 953(d) or to losses attributable to any separate unit of such foreign insurance company. In addition, these exceptions shall not apply to losses described in the preceding sentence that, subject to the rules of Treas. Reg. § 1.1503(d)-4(d), carry over to a domestic corporation pursuant to a transaction described in section 381(a).
3. Treas. Reg. § 1.1503(d)-5(c) through (e).
4. *British Car Auctions, Inc. v. U.S.*, 77 AFTR 2d 96-1441 (Fed. Cl. 1996).
5. Modifications include the inapplicability of the subgroup rules provided in Treas. Reg. § 1.1502-21(c)(2) or the overlap rule in Treas. Reg. § 1.1502-21(g). It is important to note that even though the loss is treated as incurred in a separate return year, the regulation does not state that the year is treated as a separate return year. This distinction is important because it allows the IRS to conclude that the loss can still be utilized in the year incurred because it is not a true SRLY loss.
6. AM 2011-02 (Aug. 1, 2011) was issued by Steven A. Musher, associate chief counsel (International) to Kathy Robbins, director, International Business Compliance (Large Business and International Division).

END NOTES CONT.

7. Specifically, the footnote states that:

   The cumulative register concept is implicitly referenced in Treas. Reg. § 1.1503(d)-4(c)(3)(iii), which provides that the calculation of the separate unit's aggregate consolidated taxable income shall only include income arising in the same foreign country as the DCL. The concept also is applied in Example 40 of Treas. Reg. § 1.1503(d)-7(c), where the recapture of a DCL for which a domestic use election was made was reduced, under Treas. Reg. § 1.1503(d)-6(h)(2)(i), by the amount of the DCL that would have been usable as a result of the separate unit's cumulative register.
8. Douglas S. Holland & Guy A. Bracuti, *AM 2011-002: A DCL Carryover That Arrives Without Traveling*, Tax Analysts, Oct. 10, 2011, at 202-207.

NOTICE 2011-53 PROVIDES FATCA TRANSITIONAL RELIEF

By Frederic J. Gelfond

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The prior edition of *Taxing Times* included an article describing several fundamental questions that remain unanswered as the deadline for compliance with the Foreign Account Tax Compliance Act (FATCA) draws near.[1] As discussed in that piece, FATCA was enacted in 2010 as part of the Hiring Incentives to Restore Employment Act, and imposes information reporting requirements on foreign financial institutions (FFIs) with respect to U.S. accounts and imposes withholding, documentation, and reporting requirements with respect to certain payments made to non-financial foreign entities, or NFFEs, in which U.S. taxpayers hold a substantial ownership interest.

A "participating FFI" can avoid the FATCA withholding requirements if it enters into an agreement with the Internal Revenue Service (Service or IRS), referred to as an FFI Agreement, to: (1) identify U.S. accounts; (2) report certain required information regarding the U.S. accounts to the Service; and (3) perform withholding on certain payments made to non-participating FFIs and "recalcitrant" account holders who do not provide the required information. If an FFI does not enter into an FFI Agreement, it will be subject to withholding on certain types of payments, including U.S. source interest and dividends, gross proceeds from the disposition of U.S. securities, and pass-thru payments.

As further explained in the prior *Taxing Times* piece, the Service provided preliminary guidance on the implementation of FATCA in Notice 2010-60 and Notice 2011-34. In response to those notices, the Service received numerous comment letters citing, among other things, the need for addi-

CONTINUED ON **PAGE 46**

tional time to implement significant necessary modifications to the information management systems of FFIs, withholding agents, and the Service itself.

On July 14, 2011, the Service released Notice 2011-53, which responds to many of the concerns raised in the comment letters by providing transitional relief that extends the timeline to implement the FATCA requirements. In releasing the notice, the Service stated that the proffered phased implementation approach takes into account concerns raised in comments to Notice 2010-60 and Notice 2011-34 and the IRS' desire to provide a workable timeline for FATCA implementation. According to IRS Commissioner Doug Shulman:

> Today's notice is a reflection of our serious commitment to implementation of the statute, but also a serious commitment to listen to the implementation challenges of affected financial institutions and to make appropriate adjustments to ensure a smooth and timely roll-out.[2]

Among the key aspects of Notice 2011-53 is that it provides for a June 30, 2013 deadline to enter into an FFI Agreement. As noted above, an FFI Agreement is necessary in order to be identified as a participating FFI and thus avoid FATCA withholding. The Service has indicated that having the agreement in place by June 30, 2013 will provide sufficient time for such identification to occur and to allow withholding agents to refrain from withholding that would otherwise begin on Jan. 1, 2014. This provides at least some relief for those concerned with having such an agreement in place prior to the Jan. 1, 2013 FATCA effective date.

FFIs that enter FFI Agreements after June 30, 2013 but before Jan. 1, 2014 will also be considered participating FFIs for 2014. Those FFIs, however, may be subject to FATCA withholding due to the lack of time to identify them as participating FFIs before FATCA withholding begins on Jan. 1, 2014.

The effective date for FFI Agreements entered into before July 1, 2013 will be July 1, 2013. The effective date for any FFI Agreement entered into after June 30, 2013 will be the date the FFI enters the FFI Agreement.

Notice 2011-53 also relieves FFIs from having to report gross proceeds and gross withdrawals or payments from U.S. accounts for 2013, the first year of reporting. An FFI will, however, be required to report as a recalcitrant account holder any U.S. account holder identified by June 30, 2014 for which the FFI is not able to report certain required information. This would occur for example, if the FFI fails to obtain a waiver from the account holder.

Further, the notice also provides phased implementation procedures that provide for withholding to occur in two phases. First, for payments made on or after Jan. 1, 2014, withholding agents will be obligated to withhold only on U.S. source FDAP[3] payments. Withholding for FDAP and gross proceeds will be required with respect to payments made after Jan.1, 2015. Pass-thru payments will become subject to FATCA withholding no earlier than Jan. 1, 2015.

Continuing a theme from the September 2011 *Taxing Times* article noted above, although Notice 2011-53 provides helpful transition relief, it does not respond to all the questions that taxpayers have regarding the implementation of FATCA. For example, there continue to remain key unaddressed issues, including those dealing with the definition of FFI, the expansion of the level of exemptions from FATCA, and the removal of a requirement to withhold 30 percent from payments that might have indirectly originated in the United States. Of course, a number of practical questions remain specifically for insurance companies, that relate to such things as the types of insurance products that will be deemed to be U.S. accounts, how the term "cash value" will be defined, and what they will need to do when FATCA requires an account to be closed, but local law prohibits cancellation of a contract.

Perhaps these questions will be answered in the proposed regulations the IRS and Treasury have indicated they anticipate will be released by the end of 2011 and finalized by the summer of 2012.[4] By the February 2012 date on which this tidbit has been published, readers will know if Treasury and the Service were able to release their proposed regulations in accordance with this schedule. Hopefully, by this date, the key questions relating to FATCA implementation have been addressed.

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END NOTES

[1] *See* Gelfond and Gillmarten, *FATCA and Insurance: Fundamental Questions Remain Unanswered as Compliance Deadline Approaches, Taxing Times*, Volume 7, issue 3, September 2011.

[2] *Treasury and IRS Issue Guidance Outlining Phased Implementation of FATCA Beginning in 2013,* IR-2011-76, July 14, 2011.

[3] Fixed or determinable annual or periodical income.

[4] In addition, IRS and Treasury anticipate issuing draft FATCA reporting forms in conjunction with the proposed guidance, with final forms to be published for use in the summer of 2012.

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