

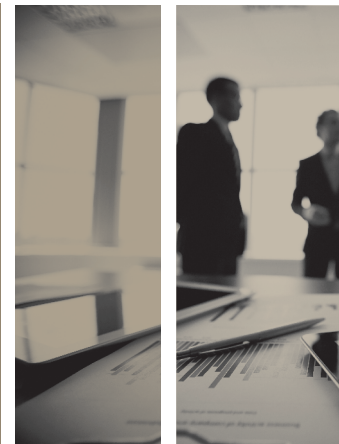


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VARIABLE ANNUITY HEDGING DIRECTIVE – A LONG AND WINDING ROAD

By Eric Bisighini and Tim Branch

“Patience and perseverance have a magical effect before which difficulties disappear and obstacles vanish.”¹

— John Quincy Adams

In the fall of 2010, the life insurance industry and the IRS began the Industry Issue Resolution (IIR) process regarding the recognition of hedging gains and losses for guaranteed benefits on variable annuity (VA) contracts. On July 18, 2014, the IRS published “I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies (LB&I-04-0514-0050)” (the Directive) which provides a safe harbor treatment for variable annuity hedging gains and losses relating to VA contracts issued before Dec. 31, 2009. The Directive addresses, at least in part, a major audit issue, similar to the §166 Partial Worthlessness Directive issued in 2012.²

The Directive instructs the Large Business & International (LB&I) division’s examiners to not challenge for certain hedges the qualification of an insurance company’s hedging transactions, the mark-to-market (MTM) values of eligible hedges (if they conform to the amounts reported in the Annual Statement) or the method of accounting for income, deductions, gains or losses. The intent of the Directive is to provide “an efficient and uniform method of accounting” for certain GMxB hedges and “allow LB&I and taxpayers to more efficiently manage their audit resources.”³ While the Directive is intended to provide financial statement and tax return certainty for a company’s tax position relative to certain hedges

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of guaranteed benefits addressed in the Directive, some questions remain for those guaranteed benefit hedges specifically not addressed in the Directive.

BACKGROUND ON VARIABLE ANNUITY HEDGING

What is variable annuity hedging, and how did it become such a big issue for life insurance companies? Life insurers began offering enhanced guarantees for variable annuity contracts in the early 2000s, especially guaranteed minimum living benefits (GMLBs), in addition to the existing death benefit guarantees (GMDBs). Guaranteed minimum death and living benefits are collectively known as GMxBs.

The most common GMDB provides a death benefit equal to the greater of the account value or the premium contributions to the variable annuity, also known as a return of premium (ROP). Later variations included a GMDB that was based on the higher of the ROP or the maximum account value (MAV) at a particular date, typically the contractholders' policy anniversary date, or a guaranteed "roll-up" amount at a specified interest rate.

There are a number of different types of living benefit guarantees that may be offered with the variable annuity. For purposes of this article, we will focus on only three of these living benefits—guaranteed minimum withdrawal benefits (GMWBs), guaranteed minimum income benefits (GMIBs) and guaranteed minimum accumulation benefits (GMABs). These living benefits introduced additional market and policyholder behavior risk to VA contracts because the contract holders could withdraw or annuitize certain amounts under the variable annuity during their lifetime at points in time that are considered adverse from the insurer's perspective.

The GMWB allows the contract holder to withdraw a certain percentage of their guaranteed principal balance (GPB) each year, regardless of whether the account value is less than the GPB. The withdrawals are subject to annual percentage limitations, generally ranging from four percent to seven percent of the GPB each year depending on issuer, and often specified dates for electing these withdrawals. The GMIB provides the contractholder with guaranteed payout amounts in the future, even if the account value does not support the guaranteed benefit. The GMAB provides the contractholder with a guaranteed minimum account value on a specified date, regardless of the market performance of the investments.

The addition of GMxBs to VA contracts increases an insurance company's market risk exposure, since the guaranteed benefits are directly related to underlying investments. Market risks include changes in equity markets, interest rates, foreign currency, etc., and the impact on the underlying separate accounts of the VA. The guaranteed benefit can be viewed as an embedded option owned by the contractholder; when markets decline, the value of the guarantee increases and the embedded option is "in the money" (ITM). The opposite is true when the markets increase. Life insurance companies developed hedging programs to manage these additional market risks in order to meet their obligations for VA guarantees.

Life insurance companies use investment derivatives in their hedging programs because of the flexibility and liquidity of the derivative markets. Derivatives can have either a direct or inverse relationship with the underlying investment index. For example, many hedging programs use equity "put options" that appreciate in value during a stock market downturn, but depreciate, or expire worthless if the S&P 500 stock index goes up. These put options appreciated substantially during the "Great Recession" of 2008-2009, but lost value in the 2009-2010 recovery, and more recently during the strong "bull market" of 2013.

There are many different types of derivatives used to manage the risks with respect to GMxB, including but not limited to equity options, futures or forward contracts, interest rate swaps and total return swaps. The derivative contracts may be either traded on a regulated exchange (e.g., S&P futures), or traded over-the-counter (OTC) and negotiated between the insurance company and an investment bank. Derivatives also vary in their maturities, ranging from three-month futures contracts to five-year through 30-year durations for OTC options and interest rate swaps.

Hedging programs are often designed to move in the opposite direction of insurance liabilities for the VA guarantees. When the S&P 500 stock index declined by over 50 percent in 2008 and early 2009, many VA guarantees were considered to be ITM since the policyholder account values were significantly less than the guaranteed amounts under the VA contracts. In this case, hedging gains from put options help offset the increase in reserve liabilities for GMxB, and allowed the insurance company to maintain the required statutory surplus for the variable annuity product.

BOOK TREATMENT FOR HEDGE GAINS AND LOSSES

Most GMxB hedges do not qualify for GAAP hedge accounting under FAS 133 (a.k.a. ASC 815) because FAS 133 requires detailed documentation and “hedge effectiveness” testing. Although most companies can design a FAS 133 test that measures the high degree of correlation between the GMxB hedge and capital market risks, they often do not meet the FAS 133 standard of a “highly effective” test that measures actuarial assumptions and policy holder behavior. The GMxB liability may also be treated as an “embedded” derivative for GAAP. Since FAS 133 does not allow hedge accounting if you are hedging a derivative (i.e., an embedded derivative) with another derivative, GMxB hedge gains and losses are generally required to be mark-to-market (MTM) through the income statement. The GMxB liability for the embedded derivative is also MTM through the income statement under FAS 157.

For U.S. statutory purposes, GMxB hedges are accounted for under SSAP 86. Although Paragraph 7 of SSAP 86 defines a hedging transaction broadly in a manner comparable to I.R.C. §1221(b)(2), SSAP 86 has similar FAS 133 hedge effectiveness testing requirements that do not allow hedge accounting for statutory reporting. Accordingly, the GMxB unrealized hedge gains and losses are recognized on MTM basis through statutory surplus.

TAX TREATMENT OF HEDGE GAINS AND LOSSES

In order to qualify as a hedging transaction for tax purposes, a hedge must be (1) entered into in the ordinary course of business, (2) used to manage the risk of price changes with respect to ordinary property, and (3) clearly identified in the taxpayer’s books and records on the day the hedge is created (I.R.C. §1221(b)(2)).

Under the Directive, a hedge of GMxB liability is a qualified tax hedge if it qualified as a hedging transaction under Treas. Reg. §1.1221-2(b) and the identification of GMxB obligations as “ordinary obligations” is made under Treas. Reg. §1.1221-2(c). Tax hedge treatment is important to insurance companies because hedge gains and losses are taxed as ordinary income, and not as capital gains and losses. Ordinary treatment is preferred, since capital losses can only offset capital gains and can only be carried back three-years or carried forward five-years, whereas ordinary losses can offset either capital or ordinary gains and can be carried back three years or carried forward 15 years for a life insurance company before expiring. Tax hedge accounting also allows the company to match the timing of the



GMxB hedge gain or loss with the timing of the item being hedged (i.e., the liability for the GMxB).

Historically there has been a diversity of practice in how insurance companies accounted for VA hedge gains and losses pursuant to IRS Regulation §1.446-4. For example, some companies used one method for VA hedge gains and another method for VA hedge losses, while other companies spread the net hedge gain or loss over different amortization periods.

GMxB HEDGE ACCOUNTING UNDER THE DIRECTIVE

Pursuant to the Directive, all the GMxB hedges are aggregated. All hedge gains and losses are then netted for the current year and allocated between VA contracts issued before Dec. 31, 2009, and those issued on or after Dec. 31, 2009. Net hedge gains for contracts issued before Dec. 31, 2009, are recognized up to the amount of the net tax deduction for the year (where the net tax deduction is the amount of GMxB accrued plus (or minus) the increase (or decrease) in tax reserves held for the GMxB). Net hedge losses for those contracts, on the other hand, are deducted on a MTM basis, except to the extent of tax reserve increases for GMxBs in the current year. In either case, excess hedge gains or losses for the current year are then carried forward to the subsequent year.

One reason for the different tax treatment of hedge gains and losses is due to the asymmetric relationship between hedging and tax reserves. For example, in a market “crash,” similar to 2008, there were significant hedge gains that were partially offset by increases in GMxB tax reserves. But in a rising market,

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such as 2010 through 2013, companies' VA hedges may generate significant hedge losses each period, but the corresponding decreases in tax reserves may begin to taper-off because the account values are much higher than the guaranteed amounts - i.e., the guarantees are "out-of-the-money" (OTM). Tax reserves can never decrease below zero and are always capped by statutory reserves.

The Directive does not provide detailed guidance for accounting for hedge gains and losses allocable to VA contracts issued on or after Dec. 31, 2009, other than that they "should be accounted for using a method consistent with the matching requirements in Treas. Reg. § 1.446-4(e)(1),"⁴ which requires "the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged."⁵

The main tax distinction between contracts issued pre- and post- Dec. 31, 2009 is that the tax reserves for VA contracts issued on or after Dec. 31, 2009 are determined under AG 43 and are subject to the safe harbor outlined in IRS Notice 2010-29, which specifies the Standard Scenario Amount (SSA) under AG 43 as the appropriate Federally prescribed tax reserve (the Federally prescribed tax reserves for pre-Dec. 31, 2009 contracts is discussed in more detail below).

The Directive provides a safe harbor method of accounting for hedge gains and losses allocable to VA contracts issued before Dec. 31, 2009, as long as the following requirements are met:

- GMxB obligations must be identified as "ordinary obligations" under Treas. Reg. § 1.1221-2(c)(2), and GMxB hedges must qualify as hedging transactions under Treas. Reg. § 1.1221-2(b).
- MTM values of GMxB hedges must conform to the values reported in the Annual Statement.
- Eligible GMxB hedges must be allocated between contracts issued before Dec. 31, 2009 and contracts issued on or after Dec. 31, 2009 using a "reasonable method." However, no guidance is provided in the Directive as to what constitutes a reasonable method.
- Method of accounting for pre-Dec. 31, 2009 contracts, as allocated according to the previous requirement, must include four specific steps.

The four steps required for pre-Dec. 31, 2009 contracts are as follows:

- **Step 1: MTM Valuation of Eligible GMxB Hedges**

Under the Directive, the total net MTM change is calculated for all GMxB hedges for the year. The MTM values must be based on the derivative market values in the Annual Statement (or audited financial statement, if appropriate). Companies must also certify the GMxB derivative values are the same as the MTM values in the Annual Statements.

The periodic (swap) payments or receipts for all GMxB hedges are then included with the net MTM hedge gain or loss to equal the Total MTM GMxB hedge gain or loss for the year. Periodic payments do not include the upfront cost for the GMxB hedge (e.g., option premium), and such payments are treated as part of the derivative cost basis.

- **Step 2: Aggregate Net Hedge Gain or Loss on all GMxB Hedges**

The MTM change is calculated for all GMxB hedges in the aggregate to minimize complexity, and reflects the fact that VA hedging is not done on a contract-by-contract basis. This step not only aggregates hedge gains and losses, it also aggregates the different hedge positions and derivatives used, which can vary by product or cohort year.

- **Step 3: Allocate Aggregate Net Hedge Gain or Loss**

The net MTM hedge gain or loss is then allocated between VA contracts issued before and after Dec. 31, 2009 (i.e., the date AG 43 became the tax reserving method) based on a reasonable allocation. The allocation must be "any reasonable method consistently used by an insurance company." The hedge gain or loss allocated to VA contracts issued on or after Dec. 31, 2009, is also required to be consistent with the matching requirements of Treas. Reg. § 1.446-4(e)(1). The Directive's instructions specify "any reasonable method" may be used to allocate hedge gains and losses between VA contracts issued before Dec. 31, 2009, and contracts issued on or after Dec. 31, 2009; implying the IRS may accept more than one method.

- **Step 4: Compute the net tax deduction for the year relating to the GMxB.**

Net GMxB tax deduction is equal to amount of accrued GMxB claims during the year plus (or minus) the increase (or decrease) in tax reserves for GMxB for the year, but not less than zero. Even if the company only partially hedges the GMxB, the full increase in tax reserves and accrued benefits for all GMxB are taken into account. It is provided that companies should use the current year's change in GMxB tax reserves, rather than using cumulative GMxB tax reserves.

Tax reserve methodology is determined by the Commissioners' Annuities Reserve Valuation Methodology (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC) in effect at the contract's issue date. For VA contracts issued before Dec. 31, 2009, the CARVM in effect is interpreted by various Actuarial Guidelines (AG), specifically AG 33 ("Determining CARVM Reserves for Annuity Contracts with Elective Benefits"), AG34 ("Variable Annuity Guaranteed Minimum Death Benefit Reserves") and AG 39 ("Reserves for Variable Annuities with Guaranteed Living Benefits").

There is some question as to the appropriate tax reserve method for GLB's issued before Dec. 31, 2009 (see the *TAXING TIMES* articles "How Are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?" (May 2011, Volume 7, Issue 2), and "Is There Another Tax Reserves Solution for Pre-2010 Variable Annuities?" (October 2013, Volume 9, Issue 3), for more background on this topic). However, the Directive does not offer any details or guidance as to what are appropriate tax reserves.

The hedge accounting safe harbor outlined in the Directive only applies to VA contracts issued before Dec. 31, 2009, and depends on whether there is a net hedge gain or net hedge loss for the year, as follows:

Step 4.a.) If a Net GMxB Hedge Gain for the Year

Under the Directive, VA hedge gains are recognized to the extent of the net tax deduction for the year relating to the GMxB in Step 4. Any excess net hedge gains for the year are carried forward and treated as hedge gains in the succeeding year. Any deferred hedge gains not taken into account within five years after the year the gains arise, are

recognized no more slowly than ratably over the succeeding five years.

The recognition of VA hedge gains under the Directive potentially avoids recognizing excess hedge gains in an economic crisis such as 2008-2009.

Step 4.b.) If a Net GMxB Hedge Loss for the Year

On the other hand, the net hedge losses for the year (after reduction for any deferred hedge gains from preceding years, or including any net hedge losses, carried forward from preceding years) are recognized for tax purposes on a MTM basis, except to extent there is an increase in GMxB tax reserves for the current year in Step 4. Any excess hedge losses are then carried forward and treated as hedge losses in the succeeding year. If the deferred hedge losses are not taken into account within five years after the year the losses arise, the deferred hedge losses are also recognized no slower than ratably over the succeeding five years, i.e., one-fifth of the excess in each year.

MTM treatment for hedge losses is consistent with the book treatment, while the deferral of excess hedge losses addresses the timing mismatch of having a GMxB hedge loss and the tax reserve deduction in the same year.

NUMERICAL EXAMPLES

The net hedge gains and losses taken into account for VA contracts issued before Dec. 31, 2009, under Step 4 above can best be illustrated through numerical examples.

Example 1. In Exhibit 1 (page 10), there are positive net hedge gains (see Step 4.a.) accompanied by tax reserve increases. This is a typical example of how a VA contract and associated hedge might behave in a "bear market." The example assumes that the contract was issued prior to Dec. 31, 2009, and that there are no hedge amounts carried forward into Year 1.

The amount of net hedge gain recognized currently in this example (line (3a)) is the amount of net hedge gain to the extent of the net tax deduction (line (1e)). Since the amount of hedge gains exceeds the net tax deduction, the remaining portion of the net hedge gain is carried forward to succeeding years (see line (2b) in Year 2).

If the amount of net hedge gain for the year was less than the

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Exhibit 1-Net hedge gain	Year 1	Year 2
1. a. GMxB accrued during year:	10,000	11,000
b. GMxB reserve, beginning of year:	1,000,000	1,200,000
c. GMxB reserve, end of year:	1,200,000	1,300,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	200,000	100,000
e. Net tax deduction relative to VA contract: (1a) + (1d), not less than 0	210,000	111,000
2. a. MTM net hedge gain for year:	250,000	200,000
b. Net hedge gains/(losses) from preceding year:	-	40,000
c. Net hedge gain: (2a) + (2b)	250,000	240,000
3. a. Net hedge gain recognized during taxable year:	210,000	111,000
b. Net hedge gain carried forward to future years:	40,000	129,000

Exhibit 2-Net hedge loss	Year 1	Year 2
1. a. GMxB accrued during year:	n/a	n/a
b. GMxB reserve, beginning of year:	1,200,000	1,000,000
c. GMxB reserve, end of year:	1,000,000	700,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	(200,000)	(300,000)
2. a. MTM net hedge (loss) for year:	(250,000)	(200,000)
b. Net hedge gains/(losses) from preceding year:	-	-
c. Net hedge gain: (2a) + (2b)	(250,000)	(200,000)
3. a. Net hedge loss recognized during taxable year:	(250,000)	(200,000)
b. Net hedge loss carried forward to future years:	-	-

net tax deduction, the entire amount of net hedge gain would be recognized during the year, and no gain would be carried forward to succeeding years.

If there was a decrease in tax reserves during the year, and the decrease was greater than the amount of GMxB accrued during the year, the resulting net tax deduction in line (1e) would be negative and limited to zero. Therefore, any hedge gain would exceed the net tax deduction and be carried forward to succeeding years, i.e., no hedge gain would be recognized during the year.

Example 2. In the case of net hedge losses (see Step 4.b.), the Directive requires such losses up to the increase in GMxB

reserves be carried forward to succeeding years, and the remaining portion of the net hedge loss (if any) is recognized in the current year. Exhibit 2 shows an example of this situation, which is typical of a VA contract in a rising market. Again, the example assumes that the contract was issued prior to Dec. 31, 2009, and that there are no hedge amounts carried forward into Year 1.

In this example, the Directive allows the entire loss on line 2c. to be recognized during the current year, since there is no increase in GMxB tax reserves.

Example 3. If there was an increase in GMxB tax reserves during Year 1, a portion of the loss (up to the increase in reserve) would have to be carried forward, as shown in Exhibit 3.

Exhibit 3-Net hedge loss, Increase in GMxB Reserve	Year 1	Year 2
1. a. GMxB accrued during year:	n/a	n/a
b. GMxB reserve, beginning of year:	1,200,000	1,250,000
c. GMxB reserve, end of year:	1,250,000	700,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	50,000	(550,000)
2. a. MTM net hedge (loss) for year:	(250,000)	(200,000)
b. Net hedge gains/(losses) from preceding year:	-	(50,000)
c. Net hedge gain: (2a) + (2b)	(250,000)	(250,000)
3. a. Net hedge loss recognized during taxable year:	(200,000)	(250,000)
b. Net hedge loss carried forward to future years:	(50,000)	-

Eric Bisighini is a Vice President of Tax at The Hartford and may be reached at Eric.Bisighini@thehartford.com.

Tim Branch is a manager, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at Tim.Branch@ey.com.

The net hedge losses, up to the increase in GMxB reserve (line (1d)), are carried forward to Year 2, where they are subsequently recognized along with the Year 2 MTM hedge losses. The remaining portion of net hedge loss in Year 1 is currently deductible.

IMPLEMENTATION RULES

If the company is under examination, or at appeals, it will have the opportunity to make the change in method of accounting in the earliest open year under examination. If the company has a number of open tax years with VA hedging issues, the Directive encourages the company to work with the LB&I examiners to adopt the Directive for a particular tax year. Flexibility to choose the appropriate tax year should have a positive impact on managing audit resources for the IRS and the taxpayer.

If the company is not under examination for any tax year, the company may file a Form 3115 request for an automatic change in accounting, although there is no guarantee the IRS will consent to the change.

In accordance with IRS Revenue Procedure 2002-18, if the new Directive method of accounting results in an adverse adjustment, the increase in taxable income is spread over four years as a §481 adjustment. Favorable adjustments (i.e., decreases in taxable income) are recognized in the year of adoption.

SUMMARY

The IRS's perseverance on this highly complex issue is to be commended. There are many complexities in adopting an accounting method that involves a hedging program with multiple market risks and different types of hedging derivatives. This Directive provides a solution, at least for contracts issued prior to Dec. 31, 2009, which leaves some uncertainty and likelihood for some continued disparity of practice in the industry for companies that have continued to sell and hedge VA business.

The Directive addresses a significant tax issue for life insurance companies that have hedged VA blocks of business. Importantly, the Directive should allow the IRS and the insurance companies to close out open audit years in a timely and cost-effective manner with respect to this issue. ◀

Note: The views expressed are those of the authors and do not necessarily reflect the views of The Hartford or Ernst & Young LLP.

END NOTES

- ¹ John Quincy Adams, 6th US President (1767-1848), BrainyQuote.com.
- ² I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012). See Arthur C. Schneider and Samuel A. Mitchell, "IRS Utilizes the Industry Issue Resolution Program to Resolve the Insurance Industry Bad Debt Issue," *TAXING TIMES* Vol. 9, Issue 1 (February 2013) at 20.
- ³ LB&I-04-0514-0050, introduction.
- ⁴ LB&I-04-0514-0050, "Examination Guidance" and Part A, Step 3.
- ⁵ Treas. Reg. §1.446-4(e)(1).