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By Christian DesRochers

A recently-decided Tax Court case dealt with the continuing issue of the value of a life insurance contract distributed from a qualified pension plan.[1] The case does not break any new ground, and deals with the valuation of a life policy before the changes made in 2005 to the section 1.402 regulations, but is interesting in the approach applied by the Tax Court to define "cash surrender value," under the pre-2005 version of regulations.[2]

The case dealt with a transaction under a Pension Asset Transfer (PAT) plan, which was promoted to the taxpayers to "transfer qualified pension assets or IRA dollars to the participant or the participant's family without significant taxation." Under the PAT plan, a life insurance policy purchased inside a retirement plan is subsequently transferred to the client, with any tax paid on the value of the policy at the time it is distributed. At the time of the transfer in December 2000, the policy had an account value of $1.368 million, subject to a $1.062 million surrender charge, resulting in a cash surrender value of $306K. As consideration for the policy, the taxpayer transferred $315K to the profit sharing plan. No income was reported on the sale of the policy.

Subsequently, in January 2001—and as part of a pre-arranged plan—the policy was transferred to a family trust and exchanged, with the same carrier, for a single premium policy with a premium exactly equal to the $1.368 million account value. However, the replacement policy provided for no surrender charge.

Faced with this set of circumstances, the Internal Revenue Service (the "Service") determined that the taxpayer had under reported gross income on the sale equal to the $1.368 million account value, less the consideration of $315K, a net of $1.053 million, approximately equal to the surrender charge of $1.062 million, and imposed an accuracy-related penalty under section 6662(a).

The essence of the case was whether in valuing the life insurance policy a reduction should be made for the surrender charge. That is, the Service argued that the fair market value of the policy was the $1.368 million account value, so that there was a $1.053 million bargain element of the sale, while the taxpayer argued that the basis of value should be the interpolated terminal reserve of $306K reported by the carrier, so there was no bargain sale.[3]

Aside from the factual determination of the value of the policy, there was also a discussion of the applicability of the revised section 402(a) regulations, which were being revised in 2005, as well as the applicability of the section 402(a) regulations generally, as the transaction was not a distribution, but a sale.

In its opinion, the Tax Court agreed with the Service on the valuation of the policy, but arrived at their conclusion under the pre-2005 regulations. Noting that the previous regulations, finalized in 1956, referred to the "entire cash value" of the contract, the Tax Court looked to the section 72(e)(3)(A)(i) and 7702(f)(2)(B) definitions of cash surrender value, as the value "without regard to any surrender charge," commenting that "we do not believe that the appearance of the adjective 'entire' before the words 'cash value' in the applicable regulations can sensibly be read to connote any lesser value than 'cash value' under section 72(e)(3)(A) or 'cash surrender value' under section 7702(f)(2)(A)." While holding for the Service, the Tax Court also held that the taxpayers had a reasonable basis for their return position and did not hold them liable for the penalties.

While the decision was not surprising, the Tax Court has to get some credit for creativity in reading a regulation in the context of a statute, in the case of section 7702, that was enacted almost 30 years after the regulation was finalized. Given the facts of the case, a simpler approach would have been to recognize the value of the exchanged policy, which was equal to the $1.368 million account value, as indicative of the fair value of the original contract.

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END NOTES

[1] For background, *see* "Determining the Value of a Life Insurance Contract: Revenue Procedure 2005-25;" *TAXING TIMES*, December 2005. *See also*, "T.D. 9223 Value of Life Insurance Contracts When Distributed from a Qualified Retirement Plan," I.R.B. 2005-39, September 26, 2005.

[2] Revenue Procedure 2005-25 applies to distributions, sales and other transfers made on or after Feb. 13, 2004. However, for periods before May 1, 2005, taxpayers may rely on the Rev, Proc, 2005-25 safe harbors. For periods on or after Feb. 13, 2004, and before May 1, 2005, taxpayers may also rely on the safe harbors in Revenue Procedure 2004-16. Revenue Procedure 2005-25 provides that the safe harbor for nonvariable contracts may be measured as the greater of:
- The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the PERC amount and the applicable Average Surrender Factor.

The PERC amount is a formulaic accumulation of the premium less cost of insurance charges.

[3] The interpolated terminal reserve standard can be traced back to Revenue Ruling 59-195, which dealt with the sale of a policy to an employee. *See* Rev. Rul. 59-195, 1959-1 C.B. 18.

LATEST IRS INDUSTRY DIRECTOR DIRECTIVE ON THE DRD FOR LIFE INSURANCE SEPARATE ACCOUNTS MAY RESOLVE MAIN ISSUE, BUT DOES IT RAISE OTHERS?

By Susan J. Hotine

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For several years the life insurance industry and the Internal Revenue Service ("the Service") have conducted a vigorous dialogue about how to compute the company's share of net investment income from segregated asset accounts underlying variable contracts. The industry has contended that the company should use the prior-law formula set forth in Treas. Reg. § 1.801-8(e) ("the Regulation") as guidance for determining another appropriate rate to calculate required interest for separate account reserves; the Service generally has not agreed. The specific focus of this dialogue has been the determination of the company's share of dividends qualifying for the dividends received deduction ("DRD"). The context for this back-and-forth discussion has included the Service's examinations of taxpayers, administrative Appeals proceedings, and the process of issuing published guidance by the Service and the Department of the Treasury ("Treasury"). For example, initial Service guidance in the form of Technical Advice Memoranda favored use of the prior-law formula of the Regulation, until Rev. Rul. 2007-54, 2007-2 C.B. 604, came to a contrary conclusion, but the Ruling was suspended by Rev. Rul. 2007-61, 2007-2 C.B. 799, in response to industry criticism.

There are signs the dialogue is working toward a conclusion. Beginning in early May of this year, taxpayers began hearing that the IRS Appeals Division is prepared to concede the issue. Then, on May 20, 2010, Walter Harris, the IRS Industry Director for Financial Services, issued an Industry Director Directive (LMSB Control No.:LMSB-4-0510-015) regarding the examination of the DRD in connection with separate accounts of life insurance companies. The May 20 Directive (in tax jargon, an "IDD") appears to adopt the industry position, although notably the Directive does not use the word "concede," and so its message is less clear than it could be.

The May 20 Directive is a revised version of an IDD with the same control number that was issued on May 17, 2010. The two key clarifications of the revised Directive are significant. First, in the "Discussion" section, the May 20 Directive adds a sentence to affirm, "With respect to calculating the company's share of a separate account's net investment income, Treas. Reg. § 1.801-8(e) sets forth a formula to be used in computing required interest at 'another appropriate rate.' See TAM 200038008 (June 13, 2000) and TAM 200339049 (Aug. 20, 2002)." Second, in the "Risk Analysis" section, in advising agents that the DRD issue should be raised if the company uses a method for computing the company's share of investment income that is inconsistent with section 812 and Treas. Reg. § 1.801-8(e), the Directive now refers to " Treas. Reg. § 1.801-8(e) (as illustrated by TAM 200038008 and TAM 200339049)." Thus, the May 20 Directive acknowledges that the two TAMs properly apply the formula of the Regulation to determine another appropriate rate for calculating required interest for separate account reserves and for computing the company's share of a separate account's net investment income.

But the message of the Directive is obscured somewhat because it does not plainly state that Rev. Rul. 2007-54 is incorrect. Nevertheless, this is the implication of the Directive, which notes (again in the "Discussion" section) that Rev. Rul. 2007-54 was suspended by Rev. Rul. 2007-61 and approvingly cites the two TAMs, which are inconsistent with the suspended Ruling. The Directive also refers to the statement in Rev. Rul. 2007-61 that the Service and Treasury intend to address the issues considered in the suspended ruling in regulations and, "until such time, the issues should be analyzed as though Rev. Rul. 2007-54 had not been issued." However, in the past four years, similar language in Rev. Rul. 2007-61 has been read by some in LMSB as allowing agents to use the analysis set forth in Rev. Rul. 2007-54, but not allowing them to cite Rev. Rul. 2007-54 as authority.

The May 20 Directive supercedes prior direction to the field in an IDD issued April 22, 2008 (LMSB Control No.: LMSB-

04-0308-010) and an issue Alert issued by the Service on July 15, 2009. However, the Directive suggests two new avenues for agents to explore in examining the DRD issue. First, it states that agents should examine multi-year comparisons of the DRD computation and determine if the company has changed its method for calculating the DRD. The Directive instructs that, if over several years there is a significantly higher company's share of net investment income, an information document request should be issued asking for the reasons for the change, as well as for a comprehensive explanation of the company's method of computing the DRD before and after the change, together with detailed computations on a separate account basis. Second, the Directive states that agents should review the computations and determine whether the facts represented in the life insurance company's computation methodology are consistent with the company's reporting for financial and state law purposes. It states that agents should issue an information document request for the company's original application for separate account treatment submitted to the state insurance department to verify that the company's treatment of the separate account is consistent with the definition under state law.

It is not clear what issues the Directive has in mind in suggesting these new inquiries. Although the change-in-methodology inquiry does sound as though some in LMSB think there are accounting method change issues to be explored in the DRD computation, IRS representatives at the FBA Insurance Tax Seminar last June indicated otherwise. But, then, to what kind of change issues are agents being directed? Does the inquiry regarding the financial and state reporting for separate accounts mean that there is a concern that companies are treating assets as segregated in variable contract separate accounts for tax purposes that are not so segregated for state law purposes? Or, are the new inquiries just an attempt to encourage agents to examine whether a company is correctly applying the formula of the Regulation for calculating required interest for separate account reserves for variable contracts? The TAMs cited in the Directive address some of the issues for application of the Regulation formula in the context of current law, but perhaps not all.

Like the IDD and Alert that it supercedes, the May 20 Directive states that the DRD issue of life insurance companies is not a mandatory examination item but, if the agent's Risk Analysis indicates that the issue is material, it should be developed. It also continues to encourage agents to communicate and collaborate with IRS Local Counsel, as well as LMSB life insurance actuaries.

IRS ACTUARIES RAISING NEW ISSUES ON AG 34 TAX RESERVES

By Peter H. Winslow

With the assistance of Internal Revenue Service ("IRS") actuaries, IRS agents are routinely raising a new issue for tax reserves held under variable annuity ("VA") contracts that provide guaranteed minimum death benefits ("GMDB"). Prior to being superceded by Actuarial Guideline XLIII ("AG 43") effective Dec. 31, 2009, statutory reserves for VA contracts with GMDB were required to be computed under Actuarial Guideline XXXIV "Variable Annuity Minimum Guaranteed Death Benefit Reserves" ("AG 34"). Under Notice 2010-29,[1] AG 34 will continue to apply as the tax reserve method for most contracts issued prior to Dec. 31, 2009, because it is the applicable interpretation of CARVM prescribed by the NAIC in effect on the date of the issuance of the contract.[2]

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AG 34 requires the calculation of an Integrated Reserve that combines GMDB with other contract benefits under various benefit streams. These benefit streams take into account an assumption that account values will grow by "a return based on the valuation rate less appropriate asset based charges." Life insurance companies generally have recomputed their AG 34 tax reserves by starting with statutory AG 34 reserves and substituting the discount rate prescribed in section 807(d)(4) (generally the applicable federal interest rate or "AFIR"). Then, a conforming adjustment is made to the account value projection rate to comply with the CARVM requirements specified in AG 34. The audit adjustment currently being proposed by IRS actuaries is to eliminate the tax reserve adjustment for the projection rate and require the rate to remain at the statutory valuation rate less asset based charges. No adjustment is proposed by the IRS agents to the AFIR discount rate used for tax reserves. IRS agents have offered the following arguments to support the position that tax reserves should use the statutory rate for the earnings assumption while at the same time using the AFIR discount rate:

1. The reference in AG 34 is to the statutory valuation rate, not to the valuation rate prescribed for tax reserves;

2. The projected future benefits assumed in computing tax reserves should never exceed the future benefits assumed in statutory reserves;

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3. An adjustment to the earnings rate is inconsistent with how tax reserves are computed for fixed annuities where no tax adjustment is made to the statutory earnings rate;

4. The interest rate adjustment required for tax reserves is intended to apply only to the discount rate, not for other interest rate assumptions; and

5. Congress could not have intended that tax reserves, as recomputed under section 807(d), exceed statutory reserves, which would be the case mathematically if the projection rate is adjusted to conform with the AFIR.

Strong counterarguments could challenge each of these points. This is a tax reserve method issue, not solely a discount rate issue. By its terms, AG 34 specifies that the forward-rate earnings assumption on account values must be based on the valuation rate (*i.e.*, the discount rate for reserves). Once the valuation rate for tax reserves is adjusted to comply with section 807(d)(2), AG 34 mandates that the forward-rate earnings assumption be conformed to the same valuation rate. Otherwise, there would be an impermissible mismatch in earnings and discount-rate assumptions that violates AG 34. Moreover, Congress prescribed the use of CARVM for tax reserves for annuity contracts. To the extent that leads to tax reserves greater than statutory reserves, they are capped. Thus, Congress contemplated that a tax-reserves-greater-than-statutory-reserves situation could occur and that the tax deduction should be limited accordingly. Further, projected benefits on fixed annuities generally are the same for tax and statutory reserves because the forward earnings rate is guaranteed by contract. The same is not true for variable contracts. Unlike fixed contracts—in the case of variable contracts the forward earnings rate is not guaranteed—the future benefits reflect the market value and investment return on the underlying assets, less expenses. AG 34 requires consistency in reserve assumptions between the discount rate and the forward earnings rate for the Integrated Reserve.

It will be interesting to see how this new proposed IRS agent position plays itself out as tax return audits mature and the issue goes to IRS Appeals.

END NOTES

[1] 2010-15 I.R.B. 547.

[2] *See* I.R.C. § 807(d)(3)(B).

SOA Annual Meeting

Taxation Section Hot Breakfast
Session 54
7-8:15 a.m., Tuesday, Oct. 19, 2010

Please join the Taxation Section for a hot breakfast. We will discuss results from our section's surveys on company tax actuaries and tax reserves modeling, as well as activities from the past year.

This breakfast is open to all meeting attendees. There is a nonrefundable fee of $10 for Taxation Section members and $25 for all others. Please include the additional fee with your Annual Meeting registration.