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PROPOSED FATCA REGULATION PROVIDES SPECIFIC GUIDANCE TO INSURANCE COMPANIES REGARDING APPLICATION AND IMPLEMENTATION

By J. Chris Karow and J. Howard Stecker

Editor's Note: This article provides excerpts from a recent Ernst & Young LLP Tax Alert, authored by Howard and Chris, which focused on the newly released FATCA proposed regulations. The article ties in with the one written by Frederic J. Gelfond and Mary M. Gillmarten and published in the September 2011 issue of *Taxing Times*, titled "FATCA AND INSURANCE: Fundamental Questions Remain Unanswered as Compliance Deadline Approaches."

BACKGROUND

On Feb. 8, 2012, Treasury and the Internal Revenue Service ("IRS") released proposed regulations that provide guidance on the application and implementation of the information withholding and reporting regime contained in the Foreign Account Tax Compliance Act (FATCA) provisions of the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147). The proposed regulations are in excess of 350 pages in length and incorporate, with significant modifications, much of the guidance provided in the three IRS Notices issued in 2010 and 2011.

The guidance provided by the proposed regulations specifically related to insurance is the first detailed set of rules provided under FATCA and incorporates many of the topics identified as issue areas in the comment letters received by Treasury from domestic and foreign

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To join the section, SOA members and non-members can locate a membership form on the Taxation Section Web page at *http://www.soa.org/tax*.

FROM THE EDITOR
TO OUR READERS

By Christian DesRochers

In this issue, we address a diverse variety of topics covering developments in the taxation of life insurance products and companies since our last issue. There were a number of rulings that are addressed. Under the facts of PLR 201152014, a partnership of banks was formed to pool and manage the banks' bank-owned life insurance (BOLI) contracts and, in the process, exchange some or all of them for new contracts. The Ruling addresses both the eligibility of the LLC to be taxed in that manner, as well as a number of the tax consequences flowing from the LLC's tax treatment as a partnership. There are two articles addressing TAM 201149021, which is one in an ongoing series of rulings dealing with the definition of "insurance" under the Internal Revenue Code. We chose to cover the topic because, although it is a property and casualty case, it deals with the definition of insurance, which also has implications for life insurance companies. Another issue that is addressed is the treatment of controlled foreign corporation reserves (CFC) under section 954(i), which permits foreign life insurers to obtain a ruling from the IRS to use local regulatory reserves in determining foreign personal holding company income. The ruling, PLR 201151008, is the fourth one issued to life insurers on the topic. Without a ruling, a CFC must compute its tax reserves under the section 807 rules. We also have a discussion of policyholder dividends and dividend accruals that also addresses the recently decided Massachusetts Mutual Case. In addition, we feature analyses of proposed regulations, including those addressing the *Foreign Account Tax Compliance Act (FATCA)* released by the Treasury and IRS in February 2012, as well as the treatment of qualified longevity annuity contracts under the Required Minimum Distribution (RMD) rules. All in all, this issue offers a wide range of articles on many different topics.

As we have done in the past, when an article is too long to include in *Taxing Times*, we publish it as a supplement. Accompanying this edition, we present another supplement. In this case, we present two articles related to the concept of material changes under the tax law, and their impact on the administration of life insurance contracts under sections 7702 and 7702A. The first, and by far the most comprehensive, article is, "They Go Bump in the Night: Life Insurance Policies and the Law of Material Change," by John Adney and Craig Springfield. In their article, John and Craig provide a comprehensive (and weighty) discussion of the concept of a "material change" under the Internal Revenue Code. The second, "Administrative Aspects of the Material Change Rules: Meeting the Challenge," is an article that Brian King and I co-authored as a follow-up to John and Craig's article that addresses administrative implications of the discussion in their article.

In the last issue, our lead article was headlined, "Partial Exchange Guidance Keeps Improving." The title was meant to be complimentary to the guidance process, and not a criticism of prior efforts. At *Taxing Times*, we are striving to be informative and to offer a range of views in the articles we present. However, in this case, we could have been clearer in the title of the article.

Taxing Times could not succeed except for all the hard work of the people who contribute their time to produce it. I'd like to thank all of the authors and editorial staff who helped to assemble this issue.

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FROM THE CHAIR
"PLAY WITH ME"

By Kristin Schaefer

Since I mentioned my 5-year-old grandson in last issue's article, I have to give equal time to my 3-year-old grandson. He doesn't really have a favorite phrase, but he does have a favorite request, at least when he visits grandma and grandpa. That is "play with me." In his 3-year-old world, that is the equivalent to our adult, working world of "spend some time with me, teach me, share your ideas."

One of the ways that we as actuaries spend time with each other and share ideas is by participating in Society of Actuaries meetings. The Taxation Section has been involved in sponsoring sessions at these meetings since its inception. This year, at the Life & Annuity Symposium coming up shortly, we will have two sessions and a breakfast. The sessions will discuss combination products involving long-term care (combined with annuity or life products) and an update on federal tax issues affecting both life insurance products and life insurance company tax. The breakfast will be highlighted by an update from the Necessary Premium Test Task Force.

We also plan to have a breakfast at the Valuation Actuary Symposium in September, as well as a session on current tax issues. Planning is getting underway for the SOA Annual Meeting in October, and we expect to have several sessions at that meeting as well. Possible topics include tax issues with hedging, long-term care combination products, and a round-table discussion with both industry and government representatives. Registration for these meetings will be coming up soon, so please sign up for the Taxation sessions and/or breakfasts if you are attending. We'd love to meet you!

Another opportunity to learn more about product tax issues will be at the Product Tax Seminar, which is sponsored by the Taxation Section, and will be held in Washington, D.C. on Sept. 21 and 22. As has been the case with past seminars, this year's edition promises to be an enlightening and well-attended event.

In addition to meeting sessions, other means of communicating with our fellow actuaries have developed over the past decade or so. These include webinars, podcasts and social media outlets such as blogs, Facebook, Twitter and LinkedIn. The Taxation Section has sponsored several webcasts over the past few years and plans to do another one or two this year, depending on when anticipated guidance from the Internal Revenue Service (IRS) is issued. We are also currently exploring establishing a LinkedIn group and hope to have it going by the time this article is published.

The Society of Actuaries is encouraging sections to become involved in producing podcasts as another means of providing communication and continuing education. At our last council teleconference, we discussed how we might be able to use podcasts to reach out to our members in a different mode. Possible ideas included summarizing *Taxing Times* articles, highlighting themes from webcasts, and promoting sessions at actuarial meetings.

As always, your Taxation Section Council members encourage your participation in any of our activities. If you have an idea for a newsletter article, meeting session, webinar or podcast, please let us know. Of course the best way to participate is by becoming a council member yourself. Section council elections will be coming up soon. If you are interested in running for the council, please contact me at the email address below, or any of the other council members, and we'd be happy to discuss it with you.

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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.

insurance companies and trade associations over the past two years. This article focuses on the provisions that apply specifically to insurance companies.

It is evident from reading the proposed regulations that Treasury put a lot of thought and effort into the drafting of the proposed regulations, listened to the comments provided and attempted to reflect those comments in the proposed rules. The insurance provisions are a solid start to providing guidance the global insurance industry can rely upon to develop the necessary administrative processes and procedures and make changes to software systems to accumulate, analyze and store the data required to achieve and maintain ongoing compliance with the FATCA rules. There are a number of areas where further dialogue and detailed commentary from the insurance industry to Treasury should help to refine the proposed regulations and further reduce the administrative burdens, including:

- Further refinements to the definitions of life insurance and annuity contracts to eliminate the need for foreign insurance companies to become proficient with US tax law definitions of these contracts;

- Expand the definition of local foreign financial institutions (FFI) so that insurance companies that meet the requirements can avoid the administrative compliance related to documentation of certain individual accounts;
- Clarify definition of forms of life insurance and annuity contracts eligible for the Grandfathered Obligations exception to withholding on contracts in force on Jan.1, 2013;
- Provide a definitive statement that indemnity reinsurance not involving administrative services is excluded from the reporting, documentation and withholding rules; and
- Modify the relationship manager definitions (entity and individual) under the pre-existing contract rules to align the concept with the various distribution system formats utilized to market insurance and annuity contracts around the world.

The proposed regulations reflect significant modifications or elaborations in several key areas that are critical to FFI and to US financial institutions, which are no longer referred to as "USFIs," but rather are referred to as part of the larger population of "withholding agents." The account identification requirements set forth in the proposed regulations incorporate substantial changes that are consistent with the extensive comments received. For pre-existing accounts, the proposed regulations include enhanced de minimis exceptions, eliminate the controversial "private banking" rules proposed in Notice 2011-34, and generally allow an FFI to rely on an electronic review of its existing records for pre-existing accounts with a balance or value of $1 million or less. For new accounts, the proposed regulations reflect a greater reliance on documentation gathered for other purposes. These rules reflect an intention to minimize the circumstances in which FFIs would need to go back to account holders for additional documentation or modify account opening procedures on a going-forward basis.

The proposed regulations extend qualification as a grandfathered obligation (which is not subject to FATCA withholding) to obligations outstanding on Jan. 1, 2013. The proposed regulations also expand the categories of FFIs that will be deemed compliant with FATCA's requirements. In addition, the proposed regulations provide greater flexibility in the treatment of FFIs in an affiliated group so that barriers to compliance by one affiliate will not taint the whole FFI group.

The proposed regulations reflect a phase-in of dates for FATCA reporting requirements applicable to FFIs as follows:

- The identity of US account holders must be reported starting in 2014 (for the 2013 calendar year);
- Information about income on US accounts must be reported starting in 2016 (for the 2015 calendar year); and
- Full information on US accounts, including information about gross proceeds, must be reported starting in 2017 (for the 2016 calendar year).

In addition, the FATCA withholding rules for FFIs will not apply to certain payments made before Jan. 1, 2015, except for payments made to payees with certain indicia that they might in fact be FFIs (prima facie FFIs). However, nonfinancial foreign entities (NFFEs) remain subject to potential FATCA withholding on US-source fixed or determinable income paid by US financial institutions beginning Jan. 1, 2014, and on gross proceeds beginning Jan. 1, 2015. Furthermore, US financial institutions must still begin to look at new, nonresident alien entity accounts differently, starting Jan. 1, 2013. The proposed regulations reserve on the definition of foreign "passthru" payments and provide that withholding will not be required on such payments before Jan. 1, 2017.

In general, for the majority of US insurance companies, which will be considered withholding agents, the proposed regulations contain a demarcation line of Jan. 1, 2013, for purposes of distinguishing between "new" and "pre-existing" accounts. Withholding agents must generally consider all documentation obtained for know-your-customer/anti-money-laundering (KYC/AML) purposes from an account holder for new accounts when determining the account holder's status for FATCA purposes. US withholding agents will be required to withhold on payments of US-source fixed or determinable annual payments (FDAP) paid to new accounts held by nonparticipating and presumed FFIs (*i.e.*, entity account holders for which appropriate FATCA certifications have not been received) and pre-existing prima facie FFI accounts starting Jan. 1, 2014, and on gross proceeds paid to nonparticipating and presumed FFIs starting Jan. 1, 2015. While participating FFIs have a phase-in period for reporting under FATCA, US withholding agents that are not FFIs will apparently be required to begin reporting information about substantial US owners of NFFEs as early as March 15, 2014, for the calendar year 2013, on a form yet to be published.

In addition, the preamble to the proposed regulations indicates that the existing Chapter 3 (*i.e.*, nonresident alien withholding and reporting) and Chapter 61 (*i.e.*, Form 1099 reporting) regulations will be amended effective Jan. 1, 2014, to conform to the FATCA provisions. As a result, in addition to the existing "reasons to know," withholding agents will be deemed to have reason to know a withholding certificate (*e.g.*, Form W-8BEN) is unreliable if the withholding agent has a US telephone number on file for the account holder, or information indicating that an account holder was born in the United States. In such a case, the withholding agent would be required to obtain additional documentary evidence in order to rely on the Form W-8BEN. Conformity also means that, under the proposed regulations, withholding agents can only rely on a Form W-8 received more than one year after a payment is made if they also obtain documentary evidence as to the nonresident alien's status. Finally, when the IRS conforms the existing regulations under chapters 3 and 61 to the FATCA provisions after Dec. 31, 2013, a withholding agent will be able to rely on a faxed withholding certificate if the withholding agent confirms that the person furnishing the form is the person named on it. Currently, this is not permitted.

In addition, the FATCA withholding rules for FFIs will not apply to certain payments made before Jan. 1, 2015.

At the same time as the proposed regulations were released, Treasury released a **joint statement** from the United States, France, Germany, Italy, Spain and the United Kingdom announcing an agreement to explore an intergovernmental approach to FATCA implementation that would allow FFIs in each country to provide the information required under FATCA to that country's tax authorities rather than to the IRS, and generally relieve FFIs in those countries from significant compliance burdens, including the need to sign an FFI Agreement. While few details are available today, the development of the intergovernmental approach is clearly a development all companies impacted by FATCA must stay abreast of as it likely will significantly impact how companies approach their compliance obligations over time.

GENERAL DESCRIPTION OF FATCA'S IMPACTS ON US AND FOREIGN INSURANCE COMPANIES

While the proposed regulations make great strides in providing guidance and reducing administrative burdens, the application of FATCA is still complex. Before launching into a discussion of the provisions specific to insurance companies,

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the following is intended to provide a quick glance at how FATCA applies to US and foreign insurance companies:

US-Based Insurance Companies

- A USFI is no longer a separate category under FATCA; instead, US financial institutions are considered withholding agents under Chapter 4.
- Companies may have withholding obligations related to insurance contracts held by foreign entities that have US owners (regardless of type of contract).
- Indemnity reinsurance assumed, other than transactions where administrative services are transferred, will generally not require the assuming company to perform withholding under FATCA on the underlying contracts even if they would otherwise meet the definition of a financial account.
- Any insurance company making payments for financial services to FFIs and NFFEs will need to establish procedures regarding potential for withholding.
- Investment funds and other non-insurance products offered by the insurance company and/or its affiliates may have FATCA withholding obligations depending upon whether the company maintains records and is handling cash flows or has outsourced those to a third-party vendor to perform.
- Cash value insurance and annuity contracts funding qualified pension plans are generally out of scope.

Foreign-Based Insurance Companies

- If foreign insurers sell any cash value insurance or annuity contracts, the company and its holding company will be classified as an FFI.
- FFIs are also withholding agents; however, withholding is generally delayed until 2017 for most payments made by foreign companies.
- Existing cash value insurance and annuities are "financial accounts" for purposes of FATCA—pure protection contracts such as term, disability, health or property and casualty insurance are out of scope.
- Cash value insurance and annuity contracts need to be identified; however, contracts in existence pre Jan. 1, 2013 can generally be treated as foreign accounts if the company has not previously classified the account as a US account and the contract is under $250,000; some aggregation rules may apply.
- Private banking rules no longer apply; however, cash value insurance and annuity contracts in excess of $1 million in value as of Jan. 1, 2013 and each calendar year-end thereafter will require more extensive electronic and manual US indicia search.
- Information collected at time of account opening largely follows AML/KYC criteria, and the IRS is modifying W-8 and W-9 forms to correspond with FATCA requirements.
- Cash value insurance and annuity contracts funding foreign pension and savings plans which meet a number of conditions are out of scope.

The remainder of this article will focus on a number of key issues that have arisen as the global insurance industry has analyzed the provisions of Chapter 4, taking into account the limited guidance provided in the legislative history and Notice 2010-60 for application to insurance companies, their products, and the affiliated groups of which they are members.

General Comment on Approach of the Proposed Regulations

The proposed regulations provide a number of specific rules across Chapter 4 that define insurance companies, and those insurance products that are financial accounts. The proposed regulations also provide guidance on reporting and withholding. For the most part, the proposed regulations rely upon existing insurance-related definitions in Chapter 1 of the Internal Revenue Code (the "Code"), such as sections 72, 101(f), 816(a), 817(h) and 7702. While it is helpful in one sense for the proposed regulations to have relied upon these existing rules, in many cases, as will be discussed below, they also create uncertainty and complexity to implement and administer. Moreover, many of the provisions of the proposed regulations—both insurance and non-insurance specific—will require foreign companies to reach conclusions about how to deal with particular fact patterns based upon a US tax law with which they may be unfamiliar.

For example, under the general definitions, annuities are defined by reference to section 72; however, section 72 has no specific definition of what is an annuity contract. Domestic life insurance companies in the normal course of developing new products sometimes struggle to determine whether new products are annuities and may request a private ruling from the IRS. Application of such rules to a foreign designed insurance or annuity contract may in many cases prove difficult. Accordingly, although insurance companies, especially those that are foreign-based, will find that many of the provisions of these proposed regulations provide welcome guidance, the application of this guidance may not be straightforward. Applying this guidance, which tends to be based on multiple

US tax law sections with many exceptions and caveats rather than bright-line tests, will require significant analysis that will then need to be standardized within systems and operational procedures. This will make implementation and ongoing compliance more complex and costly, and require extensive knowledge of US tax law and operational activities to address the proposed requirements. The discussion below summarizes the guidance provided in the proposed regulations related specifically to insurance companies and their products, and provides our observations on the business implications.

DEFINITION OF FINANCIAL INSTITUTION

Are Insurance Companies Included in the Definition of a Financial Institution?

The proposed regulations clarify that an insurance company can be classified as a financial institution for purposes of FATCA. The proposed regulations define an insurance company as a company where more than half of its business activities during the year relate to issuing insurance or annuity contracts or the reinsuring of such contracts. In order for the insurance company to be considered a financial institution, it has to issue a single cash value insurance or annuity policy. Whether an insurance company is a financial institution or not is a seminal question for foreign insurance companies under the FATCA rules. US insurance companies are not required to make this determination for FATCA purposes.

General insurance and life insurance companies issuing pure protection (term life, disability, health or property and casualty) are excluded from the definition of a financial institution. If an insurance company issues pure protection along with cash value insurance or annuities, it will be treated as a financial institution; however, as described below, only the cash value insurance or annuity contracts will be subject to the account reporting and withholding provisions of Chapter 4. (Additional withholding rules may go into effect on Jan. 1, 2017, which could result in additional withholding obligations for companies.) In effect, the burden of Chapter 4 compliance has been focused only on contracts meeting the definition of a financial account.

As an ongoing compliance matter, insurance companies that are not considered financial institutions will need to monitor development of new products and reinsurance activities to ensure they do not inadvertently issue or reinsure contracts that could cause them to be classified as a financial institution. What may be a problem for some foreign insurance companies that are primarily focused on issuing contracts not meeting the definition of an annuity under section 72, is the company may not qualify as an insurance company for Chapter 4 purposes. In such case, the company will most likely be considered a depository institution under Chapter 4 since the funds under the contracts would be treated as amounts held at interest by an insurance company. While depository institutions are treated similarly in many respects to insurance companies, the problems arise in the insurance company maintaining administration systems and procedures to track different contracts and their eligibility for a variety of exceptions under the FATCA rules. Accordingly, insurance companies issuing annuity contracts will need to assess their ability to qualify as an insurance company at the effective date of the FFI Agreement and in future years.

How Are Holding Companies of Insurance Companies Classified?

The definition of financial institution discussed above also includes a holding company of an insurance company. The proposed regulations provide a number of exclusions from the definition of a financial institution, including certain nonfinancial holding companies that have no financial institution subsidiaries. As a result of these rules working in tandem, affiliated groups that include insurance companies may find it advantageous from a compliance perspective to consider realigning the ownership structure, if possible, to minimize the number of holding companies subject to treatment as a financial institution. Any such restructuring alternatives will have to be weighed against the ability of the affiliated group of FFIs to centralize their compliance obligations at the holding company level under Chapter 4 as compared to the cost associated with such a restructuring. For multinational companies, this may be an advantage as it allows the group holding company to be the "lead FFI" for purposes of the group members' FFI application process.

The proposed regulations clarify that an insurance company can be classified as a financial institution for purposes of FATCA.

Does an Insurance Company, Which Only Issues or Reinsures Pure Protection Insurance Contracts, Have Any Responsibilities under Chapter 4?

The definition of financial institution excludes insurance companies that only issue or reinsure pure protection insurance such as term life, disability, health or property and casualty insurance. Accordingly, these companies are considered nonfinancial entities and classified as either domestic, with minimal impact of Chapter 4, or an NFFE, which may be

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subject to the withholding and reporting rules of Chapter 4 related to other payments the company receives. However, exceptions (discussed below), including active business income, may apply.

Pure protection insurance contracts are not financial accounts for Chapter 4 purposes; however, the payments under such contracts for premiums and benefits generally fall into the US tax law definition of fixed or determinable annual or periodic income (FDAP) and may qualify as withholdable payments. However, if premiums paid to a foreign insurance company relate to US risks that are subject to the US excise tax under section 4371, the premiums are not considered FDAP and would not be considered a withholdable payment for Chapter 4 purposes. Term life insurance death benefits are also excluded from FDAP, as are most insurance settlement payments under property and casualty insurance contracts and health and disability payments since these are reimbursements for a loss and not considered gross income. An NFFE may also be required to perform documentation, reporting and withholding responsibilities on other financial services payments such as gross proceeds paid on purchasing US financial instruments from other NFFEs or non-participating FFIs. Payments under reinsurance contracts (see discussion below) may also generate obligations under Chapter 4, depending upon the responsibilities of the reinsurer and the cash flows under the reinsurance agreement.

If a Company's Primary Business Activity Is To Purchase Insurance and Annuity Contracts as Investments, How Is the Company Treated under Chapter 4?

An entity whose primary business is investing in insurance or annuity contracts (a viatical or life settlement provider), whether directly or through a partnership, will be considered a financial institution. As a result, a non-US entity will be required to enter into an FFI Agreement and comply with the other reporting and withholding obligations of Chapter 4. If the investing in insurance or annuity contracts combined with other activities would not rise to the level of treating the entity as a financial institution, then the entity will be considered an NFFE if it is non-US income from investments in insurance contracts and annuities is considered passive income in determining whether the company meets the active business exception for NFFEs. Viaticals and other life settlement investors in cash value insurance and annuity contracts, including special purpose entities set up in non-US jurisdictions, may find themselves subject to the reporting and withholding compliance requirements as an FFI.

Are Foreign Affiliates of US-Domiciled Parent Companies, Commonly Referred to as CFCs, Subject to Chapter 4? How Are Disregarded Entities (Such as Single Member LLCs), Branches and US-Owned Foreign Insurance Companies Electing under Section 953(d) Treated?

CFCs are treated as FFIs with no special relief provided in the proposed regulations. The proposed regulations do not address the treatment of section 953(d) companies. Entities that are disregarded for US federal income tax purposes are similarly disregarded for Chapter 4 purposes, and the owner will be considered as the entity and payee. In Notice 2010-60, the Treasury stated that a CFC that is a financial institution is an FFI and this would appear to be the case currently. Under the subpart F rules of US tax law, the income of a CFC may be currently included in the taxable income of the US parent. However, this inclusion of the foreign entity's income has no effect on the application of Chapter 4. A CFC that is not a financial institution will be treated as an NFFE. Foreign insurance companies that have made a section 953(d) election should be treated as domestic insurance companies since section 953(d) provides such treatment for all purposes of the Code. Accordingly, a section 953(d) company would be treated as a US company and subject to the withholding agent requirements of Chapter 4. In the case of single member limited liability companies (LLCs), the owner of the LLC, not the LLC, is considered the entity for purposes of classification under Chapter 4. Accordingly, the business activities of LLCs need to be considered in determining the primary business activity of their owner. A similar rule applies to branches.

How Are Affiliated Groups Treated, Which Include FFIs Located in Jurisdictions That Have Local Laws That Currently Do Not Allow for Their Compliance with the Reporting and Withholding Aspects of FATCA?

A limited relief provision is provided for affiliated groups that have branches and affiliates located in jurisdictions that will not be able to comply with certain reporting and withholding aspects of FATCA due to conflicts with local country law. The proposed regulations provide FFIs with the ability to become participating FFIs even though they have affiliates and branches with limitations due to existing local country laws. The affiliates and branches with limitations must register as "limited FFIs" and "limited branches" for a period of up to two years ending no later than Dec. 15, 2015. During this period, the limited FFIs and limited branches must perform the due

diligence requirements of the proposed regulations, as well as agree to not open new US account or accounts held by non-participating FFIs. In addition, such limited FFIs and limited branches must identify themselves as nonparticipating FFIs to withholding agents.

For insurance companies in jurisdictions that fail to change their laws in a timely manner, the two-year deadline may be problematic, as their entire affiliated group will become non-participating at the end of that deadline. As insurance companies will find it difficult to move accounts out of those jurisdictions, close accounts, or withhold on payments relating to insurance contracts to become participating FFIs, this deadline may be particularly problematic. Treasury should consider ways to clarify and eliminate the "cliff" effect if affiliated groups have FFIs in jurisdictions that do not modify their laws in a timely manner.

DEFINITION OF FINANCIAL ACCOUNT AND EXCLUDED CONTRACTS

What Forms of Insurance Are Considered Financial Accounts for Chapter 4 Purposes?

Cash value insurance and annuity contracts are considered financial accounts. Cash value insurance is defined by reference to section 7702 with modifications that eliminate all of the testing provisions, including section 101(f) and the diversification requirements under section 817(h). Annuities are defined as contracts that meet the requirements of section 72 without regards to subsections (s) and (u) and section 817(h). Term life insurance is specifically excluded from the definition of financial account if it has equal periodic premiums and the amount paid upon termination of contract before death cannot exceed premiums paid as adjusted for mortality and expense charges. However, any amount held by an insurance company under an agreement to pay or credit interest thereon is treated as a depository account and included in the definition of financial account.

Defining cash value insurance by reference to section 7702 while eliminating the cash value accumulation and guideline premium testing provisions leaves the focus on treatment of the contract as life insurance under local law and treating endowment contracts as life insurance. Though, technically, section 7702 does not apply to contracts sold pre-1984, the inclusion language to disregard section 101(f) makes it more likely the intent of the statute is to cover all life insurance contracts. By defining annuities with reference to section 72, eliminating the required distributions rule under subsection (s) and the prohibition on non-natural persons owning annuities under subsection (u), the definition becomes very expansive.

Deferred annuities and payout annuities all are encompassed under section 72; however, neither the Code nor regulations contain a definitive definition of what is an annuity contract. With the proposed regulations' modifications to section 72, it is likely that many—if not most—"annuity like" contracts will qualify as an annuity for purposes of Chapter 4. This is especially true of payout annuities that generally meet the requirements of an annuity. However, US-based life insurance companies sometimes struggle to determine if new contract forms—especially with a deferral period involved—will qualify as an annuity under section 72. So, it is very likely foreign life insurance companies will face similar challenges in determining if their contracts qualify as annuities. If the contracts do not qualify under section 72 as an annuity, such contracts should be classified as amounts held at interest by an insurance company and treated as depositary accounts. However, depository contracts are eligible for a lower threshold de minimis rule for due diligence purposes. In either case, the contract should be classified as a financial account for FATCA purposes.

For both cash value insurance and annuity contracts, the requirements of section 817(h) related to diversification of the investment portfolio of variable contracts is waived for Chapter 4 purposes. Accordingly, cash value insurance and annuity contracts issued by foreign insurance companies that are funded by separate accounts will not need to meet the diversification of investments requirements in order to meet the definitions provided in section 7702 or section 72. However, if the owners of the annuity contracts issued by foreign insurance companies have too much control over the underlying assets, the IRS might be inclined to apply the investor control rules to deem the underlying assets as owned by the contract owner. This is just one of many uncertainties that come into play with the current definitions of life insurance and annuity contracts for Chapter 4 purposes. Also, if annuity contracts are used as the funding source for a pension or savings plan, such contracts may qualify for one of the exceptions to reporting and withholding (see discussion below) and avoid the administrative burden of identifying whether the account is owned by a US person.

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What Requirements Must a Contract Meet in Order To Be Classified as an Annuity under Chapter 4?
The definition of an annuity, as discussed above, is linked to section 72 with modifications to eliminate subsection (s), dealing with required distribution rules; subsection (u), which provides a prohibition on non-natural owners; and section 817(h), requiring investments held under variable life or variable annuity contracts to meet certain diversification requirements.

Code section 72(a) provides that gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity; however, there is no definition of an annuity contract or "any amount received as an annuity." The accompanying regulations generally provide contracts will be covered under section 72 in accordance with customary practices of life insurance companies. The IRS, in a variety of private letter rulings spanning several decades, refers to numerous textbook definitions of an annuity along with a description from a Senate report in 1982, which described a commercial annuity as "… a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder's investment in the contract) and income…." The IRS rulings and case law generally focus on the annuitant/owner having an interest in only the periodic payments and not any principal fund or source from which they are derived. However, US courts have distinguished between periodic payments under an annuity versus periodic payments of interest.

For foreign life insurance companies in particular, the determination of whether a contract is an annuity or a contract held at interest may not make much difference for Chapter 4 reporting purposes. In determining if a company is an insurance company for Chapter 4 purposes, more than half of the business during the calendar year must be from issuing or reinsuring insurance or annuity contracts. For this purposes, it appears the company must first determine if its contracts meet the requirements of an insurance or annuity contract.

The term "insurance" is not defined in the regulations; however, using a general definition would likely encompass most forms of life, health or general insurance. The more difficult analysis may be related to contracts that qualify or fail to qualify as annuity contracts for the reasons mentioned above. If the number of contracts that fail treatment as annuity contracts is large enough, the company may not be able to meet the definition of an insurance company; in which case it seems such entity would be best classified as a financial institution that accepts deposits in the ordinary course of business. In either case, an FFI Agreement will likely be required. However, as discussed below, depository accounts in effect as of Jan. 1, 2013 may receive more generous treatment under the grandfather provisions than most annuity contracts other than those that have a term certain. The determinations made by the foreign insurance company must be based upon the facts related to each contract form issued and how section 72 applies to the terms of the contract.

Are Pure Insurance Contracts Issued by an Insurance Company That Also Issues or Reinsures Cash Value Insurance or Annuity Contracts Subject to Treatment as a Financial Account?
The preamble to the proposed regulations provides that pure insurance protection contracts such as term life, disability, health, and property and casualty insurance are not financial accounts; however, there is currently no definitive statement in Chapter 4 to this effect. An insurance company issuing cash value insurance, annuities and pure insurance protection products will be treated as a foreign institution since it only takes one cash value insurance or annuity contract to cross the line. However, if the business is dominated by selling contracts that fail to qualify for treatment as an annuity and, thus, are treated as depository accounts, the company may not be able to demonstrate that more than half of its business activity is issuing insurance contracts and could be treated as a depository institution. This outcome may not be all bad since, as written, the proposed regulations contain a few benefits which are not readily available to insurance companies.

Does the Depository Account Exception to the Term "US Account" Maintained by an FFI During a Calendar Year Apply to Cash Value Insurance or Annuity Contracts?
An exception to the term "US account" is provided for depository accounts that do not exceed a $50,000 threshold, taking into account certain aggregation rules. Cash value insurance and annuity contracts are not eligible for this exception; however, contracts that fail treatment as an annuity and are treated as amount held at interest by an insurance company are treated as depository accounts and may take advantage of this exception. As discussed below, other rules may provide for grandfathering of certain contracts from reporting and/or withholding.

How is Reinsurance Treated under Chapter 4?
The definition of an insurance company includes the reinsuring of insurance or annuity contracts, although the term "reinsurance" is not defined. The definition of a financial account includes any cash value insurance contract or annuity contract issued or maintained by a financial institution, but provides no specific reference to reinsurance. And, as discussed below, a withholding agent is any person who has control, custody, disposal or payment of a withholdable payment. While Notice 2010-60 referred specifically to reinsurance, the proposed regulations provide no guidance related to reinsurance other than to include it in the definition of an insurance company. Since the definition of a financial account refers to contracts issued or maintained by the financial institution, the reference to the latter condition appears to be a vague reference to reinsurance. Assumption reinsurance of cash value insurance or annuity contract should cause the assuming insurance company to become the future withholding agent and subject it to Chapter 4 requirements on the reinsured contracts.

However, indemnity reinsurance contracts covering cash value insurance or annuity contracts, although considered financial accounts, should not cause the assuming company to have Chapter 4 responsibilities for documenting, reporting or withholding on the underlying insurance risk reinsured, unless the reinsurer steps into the shoes of the direct writer for all purposes, including administrative tasks such as collecting premiums and paying claims. For many indemnity reinsurance contracts, the reinsurer is assuming mortality or longevity risk, not the future payment of cash value. Short of the reinsurance company replacing the direct writer, the reinsurance contract should not be considered a financial account. In most reinsurance, the reinsuring company's obligation is to the ceding insurance company; it has neither the control over payments to the policyholders, nor the information on the underlying policies to perform any of the Chapter 4 requirements. Treasury should consider adding a definitive statement to the regulations to clarify treatment of reinsurance in order to simplify compliance efforts.

Are Pension and Other Retirement Contracts Classified as Financial Accounts?
Two broad categories of savings accounts, regardless of the type of financial product used to fund the account, are excluded from the definition of financial account. The first category relates to retirement and pension contracts that are either (i) held by certain retirement or pension funds or (ii) subject to government regulation as a personal retirement account or registered or regulated as an account for the provision of retirement or pension benefits under the laws of the country in which the FFI that maintains the account is established or in which it operates. The second category relates to tax-favored savings vehicles for purposes other than retirement established in the jurisdiction in which the FFI that maintains it is established or in which it operates. Both categories of savings accounts must also meet certain criteria in the jurisdiction in which the account is maintained, including having tax-favored status, contributions limited to earned income, annual contributions not exceeding $50,000, and penalties applicable to withdrawals made prior to specified age requirements. See discussion below for certain retirement funds that are deemed to have met the FFI reporting requirements without formally entering into an FFI Agreement.

The definition of retirement-type contracts is very similar to the broad range of tax-favored plans provided under US tax law, which include separate pension and profit-sharing plans that hold assets and individual retirement accounts where individuals establish accounts to hold tax-deferred contributions and the earnings thereon. Interestingly, the rules do not place limits on the type of funding contract; so cash value insurance or annuities held in this type of account fall within this exception to the definition of financial account even though there are restrictions on the use of such contracts under US pension plans. While the rules are not clear, we believe this exception should also be available to contracts used to pay a pension benefit. This would be similar to the common practice in the United States for retirees to transfer their balance form a pension or other retirement contract into an individual retirement annuity, in order to pay benefits. The second type of exempted program, the non-retirement savings vehicle, seems to have been formulated with products such as UK ISAs or Canadian government-regulated savings account in mind. It remains to be seen whether the litany of rules established to exempt foreign pension and saving plans from Chapter 4 compliance are flexible enough in practice. For instance, in the United Kingdom, the limitation on pension contributions is currently £50,000, which would fail the limitations provided under the exemption.

For many indemnity reinsurance contracts, the reinsurer is assuming mortality or longevity risk, not the future payment of cash value.

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Is Cash Value a Defined Term under Chapter 4?
A cash value insurance contract is defined as an insurance contract with a cash value greater than zero. Cash value is defined as the greater of (i) the amount the policyholder is entitled to receive upon surrender or termination of the contracts without reduction for surrender charges or policy loans, or (ii) the amount the policyholder can borrow under the contract. Cash value does not include (A) personal injury or sickness benefits or a benefit providing indemnification of an economic loss incurred upon the occurrence of the event insured, (B) refunds of premiums to policyholders, or (C) policyholder dividends other than termination dividends on term insurance, personal injury or sickness, or other pure insurance contract.

Ultimately, cash value is an amount that the owner of a policy can get before death. The determination of cash value should be consistent with how most insurance companies maintain their policyholder account or accumulation values related to cash value insurance and annuity contracts. Companies may be able to simplify the process if they can validate that the loan amount is never greater than the account or accumulation value. The exclusion of return premiums and policyholder dividends also serves as a further clarification of the definition of which insurance products are subject to Chapter 4 documentation and reporting requirements. Likewise, while buried in the definition of cash value, the exclusion for personal injury and indemnification payments on economic loss incurred is a further clarification that disability, health, and property and casualty insurance benefits do not constitute cash value and, thus, such insurance contracts are not subject to Chapter 4. However, based upon the rules contained in the proposed regulations, the addition of a return-of-premium benefit may cause a term insurance contract to be treated as having a cash value and thus treated as a financial account.

Are Insurance Companies Eligible for Any of the Deemed-Compliant Exceptions to Registering as a Participating FFI?
Two categories of FFI may be able to qualify as a deemed-compliant FFI and, thus, be exempt from withholding: registered and certified FFIs. Registered deemed-compliant FFIs must register with the IRS to declare their status and attest to certain procedural requirements. Certified deemed-compliant FFIs are not required to register with the IRS, but must certify to withholding agents that they meet the relevant requirements through the use of Form W-8. Registered deemed-compliant FFIs are broken into four sub-categories, of which only two may apply to insurance companies: local FFIs and nonreporting members of participating FFI groups. However, the list of entities that can qualify as local FFIs does not mention insurance companies; thus, they are not eligible for this exception. The nonreporting member exception requires the FFI to transfer any pre-existing accounts that are identified as US accounts to a participating FFI in the expanded affiliated group. The certified deemed-compliant exception has five subcategories; however, only one is likely to apply to insurance companies dealing with low-value accounts. To qualify for the low-value account exception, the affiliated group cannot have assets greater than $50 million.

The current deemed-compliant provisions do not provide much administrative relief to insurance companies as currently written. The local FFI exception would be the most advantageous exception for insurance companies; however, insurance companies are not a covered organization. Treasury has asked for comments on applying the local FFI deemed-compliance status to insurance companies. The exception for nonreporting members could apply to insurance companies; however, the requirement to transfer accounts identified as US accounts to another FFI is problematic because under most countries' insurance laws, it is difficult to quickly terminate a policyholder's insurance contract. In some instances the only way to terminate a contract is through a novation or assumption reinsurance of the insurance contracts that are difficult to implement under regulatory rules—especially cross-border. Even if this were practical, the $50 million affiliated group asset limitation would severely limit its applicability.

REPORTING REQUIREMENTS

Do Specific Rules Apply to Insurance Contracts Issued or Maintained by an Insurance Company Subject to an FFI Agreement?
The general FFI Agreement rules for determining the status of an account holder, and identifying and documenting whether an account is a US account, apply to insurance companies and their products. There are several specialized provisions related to the due diligence for pre-existing entity and individual accounts as of Jan. 1, 2013 for cash value insurance and annuity contracts. In particular, if an entity or individual holds cash value insurance or annuity contracts issued before the effective date of the FFI Agreement, and their aggregate value is less than $250,000 as of that date, the FFI is not required to document the accounts as a US account subject to review, although the insurance company

may choose to do so. Accordingly, payments made on these pre-existing accounts are not considered reportable as a US account. However, if the insurance company elects to apply the $250,000 pre-existing contract exception, it will need to track the cash value of the affected accounts since it is required to document and report the account in the year after its year-end cash value exceeds $1 million.

To determine these various thresholds, the FFI is required to aggregate all cash value insurance and annuity contracts maintained by members of an affiliated group or individual, but only to the extent computerized systems link the accounts by reference to a common data element, such as a client number or taxpayer identification number, and allow account values to be aggregated. The FFI will also be required to aggregate accounts held by entities and/or individuals that a relationship manager has the ability to aggregate. The relevant account value is the balance or value of the aggregated accounts as determined for purposes of reporting to the account holder. For insurance companies, the ability to exclude pre-existing contracts from the documentation requirements for both entity and individual accounts is a significant reduction in administrative burden related to these contracts. The initial threshold of $250,000 will exclude a significant portion of pre-existing contracts, and the requirement that the status of the account does not change until it reaches $1 million provides additional relief from administrative burden, although it will require account balance monitoring capabilities to ensure compliance.

The vast majority of affiliated groups of insurance companies generally do not have computer systems that are capable of combining policy-level details across entities and often, due to differences in products or acquisitions, within entities. As a result, the pre-existing account exclusions for insurance companies are likely to be determined on an account-by-account basis; however, some companies may have the ability to aggregate contracts. Accordingly, insurance groups will need to determine their ability to aggregate information and document their findings. In addition, these groups must put in place monitoring systems to retest each pre-existing account on subsequent calendar year-end and be able to move an account to reportable status should its value exceed $1 million.

The requirement to aggregate contracts by a relationship manager may be more difficult to apply. A relationship manager must be an officer or employee of the company who advises account holders on an ongoing basis on matters such as fiduciary, estate planning or philanthropic needs, among others. However, a person is only a relationship manager if, taking into consideration the aggregation rules, the value of the accounts the relationship manager works on exceeds $1 million. For many insurance companies which rely upon third-party agents and brokers to market their products, there may be no relationship managers since those individuals would not be an officer or employee of the company. Insurance companies with employee sales forces must review their service provisions to determine whether the relationship manager definition applies to them. Under the regulation, a relationship manager is an employee who provides ongoing services on a wide range of financial issues. It is unlikely that retail insurance arrangements would fall within the definition. Conversely, insurance companies that market cash value insurance and annuity products to affluent markets through employees as their distribution source may find the aggregation requirement for relationship managers to be a major administrative hurdle to overcome.

Do the General Rules for Determining a Substantial US Owner Apply with Regards to Cash Value Insurance and Annuity Contracts?

Withholding agents, including participating FFIs, must determine if the owners of a financial account such as a cash value insurance or annuity contract are US persons. For payments to NFFEs, the withholding agent must determine if there are any substantial US owners of the payee. Substantial US owner is generally defined as ownership of 10 percent or more of the stock, profits interest or capital in a partnership or a portion of a trust. For insurance companies and certain investment vehicles, the 10 percent ownership percentage is reduced to zero so that any US ownership of the stock of a corporation (vote or value), profits or capital interest in a partnership or any interest in a trust will require the entity to be considered related to a substantial US owner. In some ways, this rule simplifies the analysis for withholding agents as they do not need to ascertain the level of ownership, only the fact that a US person or owner has some level of ownership. One area of concern is that AML and KYC rules in many jurisdictions require entities to disclose owners at a higher threshold than 10 percent, so modifications to these processes may be required in order to capture the information needed to comply with the FATCA reporting requirements.

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How Does an FFI Determine Who Is the Owner of a Cash Value Insurance or Annuity Contract?

A person or entity treated by the financial institution as owning an account is generally considered the holder of the account for purposes of determining if it is a US account. For cash value insurance and annuity contracts owned by an entity, the general ownership rules apply. An individual who owns a cash value insurance or annuity contract and is able to access the cash value or change beneficiaries will be considered the holder. Otherwise, the beneficiary is considered the holder. In the case of a grantor trust under which an individual is treated as the owner of the trust, the account will be treated as held by the owner of the trust. As foreign companies develop systems and procedures to implement the Chapter 4 requirements, the procedures and documentation related to determining the holder of financial accounts for purposes of the FFI Agreement may need to be configured with logic to identify and track the payee on a withholdable payment payable to an NFFE. For example, while an insurance company may have on its books and records limitations on the holder of a policy to the cash value (such as in the case when an irrevocable beneficiary is named), the trust provisions technically require the insurance company to make a determination of ownership applying relevant trust law and US tax law, a difficult matter for an insurance company located in a different jurisdiction.

How are the General Information Reporting Requirements for FFIs And NFFEs Modified by Any of the Specialized Insurance Rules?

Information reporting is required for financial accounts related to US persons maintained by FFIs and withholdable payments made to NFFEs with substantial US owners. Rules related to determining the holder of cash value insurance and annuity contracts as financial accounts, the definition of cash value, and the identification and documentation procedures for pre-existing accounts related to cash value insurance and annuity contracts are all taken into account in applying the general information reporting requirements for FFIs. In regards to payments to NFFEs, there are no specialized insurance rules that apply other than in the determination of the amount of an NFFE's passive gross income. Annuity payments, death benefits, and amounts received from a pool of insurance contracts are all taken into account as passive income. Accordingly, the application of the information reporting rules should be relatively uniform across an affiliated group that includes insurance companies.

How are Mutual Insurance and Other Non-Stock Insurance Organizations Treated for the Exceptions to Reporting for NFFEs?

A withholding agent is not required to withhold on a withholdable payment if the withholding agent can determine the payee is an excepted NFFE. An excepted NFFE means a publicly traded corporation on one or more established securities markets and its affiliated entities, certain territory entities and certain other specialized entities, and active NFFEs. An active NFFE, as discussed above, has less than 50 percent of its income from passive sources or less than 50 percent of its assets from the production of passive income. The global insurance industry has many organizations that are owned by policyholders, such as mutual insurance companies, non-stock health insurance companies and risk retention groups. While these organizations, if not otherwise classified as an FFI, should qualify under the active NFFE exception, it is interesting that these organizations that are public by their ownership structure are not included in the definition of a publicly traded company since they do not have stock traded on an established securities market. The compliance burden associated with demonstrating the company's compliance with the active NFFE rule is more burdensome than being exempted due to the ownership structure of the company. Hopefully, Treasury will be willing to consider some form of administrative relief for these types of organizations to further reduce the compliance burden.

WITHHOLDABLE PAYMENTS INCLUDING PASSTHRU PAYMENTS

How Do Premiums and Benefit Payments Impact the Computation of FDAP Used To Determine a Withholdable Payment?

The term "withholdable payment" is a defined term in the

FATCA statute and is a key term in the sections of the proposed regulations related to withholding agents. For instance, a withholding agent must generally withhold on a withholdable payment to an FFI that is not participating, or on a withholdable payment to an NFFE that fails to provide the proper documentation on owners or prove its status as excepted. Both situations depend upon the definition of a withholdable payment that is defined as any payment of US source FDAP income (fixed or determinable annual or periodic income) and gross proceeds from certain sales and dispositions of property that can produce US-sourced interest or dividend income. FDAP is defined by reference to the regulations under section 1441. If the source of a payment cannot be determined at the time of payment, it must be treated by the withholding agent as US-sourced.

The definition of FDAP under section 1441 includes premium income; however, certain exclusions under the Code apply that do not depend upon the US versus foreign status of the payee. These include life insurance death benefits under section 101, the return of basis component of annuity payments, and withdrawals from life insurance contracts from the cash value to the extent they do not exceed premiums paid under section 72. FDAP does, however, include the taxable portion of annuity payments or the taxable portion of partial or full surrenders from annuities and life insurance contracts. In addition, FDAP does not include premiums that are subject to the US excise tax under section 4371. While it is hoped that withholding will only be required on a small percentage of what would otherwise be withholdable payments, those payments that are subject to withholding may require the insurance company to compute the amount subject to withholding, which will likely become a manual process due to the infrequency and uniqueness of each payment. The mere crediting of amounts to cash value by the insurance company should not be considered a withholdable payment as it is not considered an FDAP payment to the policyowner. This suggests that passthru payment withholding on recalcitrant policyowners can be deferred until payment, when the insurance company should have greater contact with the customer.

Do Foreign Insurance Companies Treated as Participating FFIs Have Any Withholding Obligations Prior to Jan. 1, 2017, When the Passthru Payment Rules Become Effective?

The FFI Agreements treat the company as a US withholding agent and responsible for withholding on withholdable payments and foreign passthru payments as required under Chapter 4. Withholding on withholdable payments to FFIs is effective Jan. 1, 2014, and on foreign passthru payments is effective Jan. 1, 2017. There are certain exceptions to the withholdable payment effective date that may delay withholding until Jan. 1, 2015. Withholding on withholdable payments to an NFFE is required after Dec. 31, 2014. Generally, participating FFIs (other than custodial institutions, other intermediaries and flow-thru entities) will not have to deal with withholding until the passthru payment rules become effective Jan. 1, 2017; however, some situations may exist where an insurance company issues cash value insurance or annuity contracts that are funded directly by investments in US-sourced investments. In this situation, the participating FFI may have a withholding requirement under Chapter 4 as a withholding agent on a withholdable payment when withdrawals or surrenders are paid since the amount would be US-sourced and considered FDAP.

Are US Insurance Companies Subject to New Withholding Requirements as a Result of FATCA?

US insurance companies are treated as withholding agents under FATCA in a manner similar to their role under section 1441. FATCA expands the withholdable payments to include payments by US insurance companies to foreign entities with substantial US owners who do not provide the required documentation and nonparticipating FFIs. FDAP payments made with respect to any type of insurance contract to such an entity could be subject to withholding. Under section 1441, only payments to US individuals located outside the US are subject to withholding. The new withholding obligation takes effect for payments made beginning Jan. 1, 2014. US withholding agents will also begin to report information about substantial US owners of NFFEs in 2014 for the 2013 calendar year.

The term "withholdable payment" is a defined term in the FATCA statute and is a key term in the sections of the proposed regulations related to withholding agents.

US insurance companies generally have processes in place to identify life insurance and annuity contracts with individual owners located in a foreign jurisdiction and apply withholding as appropriate on withdrawals and benefit payments. The FATCA expansion will involve companies searching for foreign entities, including trusts, who own contracts and/or to whom withholdable payments are made in order to determine if the entities have any US ownership (and

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then obtaining documentation); or, if a financial entity, to determine whether they are a participating FFIs. The rules regarding grandfathered obligations discussed above apply to exclude payments related to life insurance contracts and term certain annuities outstanding as of Jan. 1, 2013 from the new withholding rules. Insurance companies will need some way to identify within their policy administration systems or manual payment processes contracts that are subject to the grandfather rule.

Do Payments Made in the Ordinary Course of Business of an Insurance Company Qualify as Withholdable Payments?

Payments in the ordinary course of the withholding agent's business for nonfinancial services, goods and the use of property are excluded from the definition of a withholdable payment. As a result, wages, office equipment leases, awards, prizes, and other tangible and intangible nonfinancial services property are excluded. However, interest and dividends paid and payments for financial services are not considered ordinary course payments. The term "financial services" is not defined. In an insurance context, claims payments by the FFI to policyholders should likely be considered nonfinancial services since they are for reimbursement of an insured event and excluded from FDAP; however, settlement payments under reinsurance contracts are likely to be considered financial services in nature and includible in FDAP. Other types of payments for financial services such as gross settlements with counterparties may be withholdable payments if paid to an NFFE or a non participating FFI. Commissions paid in connection with the sale of cash value insurance and annuity contracts may also be subject to withholding if they are considered as related to a financial service. This is a point that hopefully future guidance will clarify.

Are There Exceptions to the General Withholding Rules That Eliminate the Withholding Requirements for Categories of Insurance Contracts?

The FFI Agreement generally requires withholding on withholdable payments or passthru payments when made; however, payments made under grandfathered obligations are excepted from withholding. A grandfathered obligation means any legal agreement that produces or could produce a passthru payment that is outstanding on Jan. 1, 2013. For purposes of this rule, an obligation includes debt instruments defined in section 1275(a)(1), a life insurance contract payable on the earlier of attaining a stated age or death, or a term certain annuity. However, a grandfathered obligation does not include legal agreements treated as equity or that lack a stated expiration or term such as a savings deposit, demand deposit, brokerage agreement, custodial agreement, or similar agreement to hold financial assets. Any material modification of a grandfathered obligation will result in it being treated as newly issued as of the effective date of such modification.

The grandfathered obligations provision should allow FFIs to exclude endowments and at least some cash value life insurance contracts in existence on Jan. 1, 2013 from future withholding obligations. However, the current wording seems to imply that a life insurance contract must be payable at the earlier of death or a stated age, which would appear to exclude life insurance contracts with no fixed maturity date. Thus, a traditional endowment will qualify, as will a life insurance contract that is payable at the earlier of a stated age (*i.e.*, 100) or at death. This leaves in question the treatment of a life insurance contract that does not "force" the payment of the death benefit at the final age covered by the relevant mortality table. While this approach might be superficially consistent with the general requirement that an obligation must have a "stated expiration or term," it is patently inconsistent with the section's goal of appropriately easing the administrative burden.

This distinction may significantly increase the administrative burden, as most life insurance policy forms will have to be reviewed and only those containing a stated maturity age will be grandfathered. This issue could be rectified by simply stating that the term "payable at death" is a stated term for purposes of the proposed regulations. While it could, perhaps, be argued that this is currently the case, this issue needs to be clarified. Any concerns relative to the inclusion in the definition of a grandfathered obligation of a life contingency as a stated period should be ameliorated by the fact that life insurance companies are generally considered the only companies allowed to provide a mortality risk benefit.

With regards to annuity contracts, the grandfather provision only applies to term certain annuity contracts that are a small subset of the larger annuity population. The proposed regulations do not define what is meant by a term certain annuity contract; however, a general industry definition would include contracts in payout status for a specified number of years, such as structured settlements or lottery annuities. This leaves the proper treatment of payout annuity contracts, for life or life and a period certain, under the grandfathered obligations provision as uncertain. The apparent exclusion of many annuities that qualify under section 72 is even more curious given that annuity contracts that do not meet the definition of section 72 (see discussion above regarding depository

contracts) should qualify for the grandfathering provisions as a debt instrument.

The real cause for concern is that, as noted above, the regulation uses the section 1275(a)(1) definition of debt instrument; however; section 1275(a)(1)(B) excludes from the definition of a debt instrument annuity contracts that qualify for section 72 treatment. As a result, deferred annuity contracts and payout annuities for life, which are subject to section 72, do not appear to currently qualify for the exclusion from withholding under the grandfathered obligations provision. One could perhaps argue that the intent was that a life annuity is a term certain annuity since the payments will extend for the life of the annuitant, and since this is the only place in the regulations where this distinction is, perhaps inadvertently, made.

The grandfathering rule will require insurance companies to develop systems and processes to identify contracts as of Jan. 1, 2013 and tag them for future reference. In addition, while the contracts may be exempted from withholding, the contract may still be subject to the due diligence procedures for identification and reporting of US owners. Finally, the potential for a grandfathered contract to be treated as a new contract due to a material modification of the contract terms is another example of where the proposed regulations impose complexity upon the insurance company that will require monitoring systems or procedures to identify and properly handle the situations in order to remain in compliance with FATCA. Hopefully, future guidance will help to clarify this provision as it now appears to create rather than reduce administrative burdens.

When a Cash Value Insurance or Deferred Annuity Contract Is Converted to a Payout Annuity, How Is the New Contract Classified for Chapter 4 Purposes?

If material modifications are made to financial accounts treated as grandfathered obligations for withholding purposes, the contract is considered a new contract as of the effective date of the modifications. There are no specific rules related to the conversion of a cash value insurance or deferred annuity contract to a payout annuity; however, this is likely a material modification of the contract. Accordingly, the grandfathering exception to withholding will not apply to the new contract.

Implications and Final Observations

The proposed regulations are a solid start to providing guidance to the global insurance industry on how FATCA applies to its products and customers. The focus on the use of definitions under existing US tax law to define life insurance and annuity contracts presents considerable hurdles for foreign insurance companies, not familiar with these rules, working through the compliance issues raised. However, it does provide a platform from which the industry can provide detailed comments and proposals to Treasury to refine and focus the rules in order to make the proposed regulations more efficient, clearer, and less burdensome.

The key issue for insurance companies continues to be the overall complexity of the task required in order to be compliant with FATCA. Many insurance companies use a large number of administration systems to manage their in-force contracts that generally do not tie together with other systems. As a result, the burden of searching for US indicia will continue to be a major administrative hurdle. The complexity will carry over to the foreign insurance company's communications plan to employees, agents and brokers to train them on the administrative and systems changes required by FATCA and the impact to policyholders.

The views expressed are those of the authors and not of Ernst & Young LLP.

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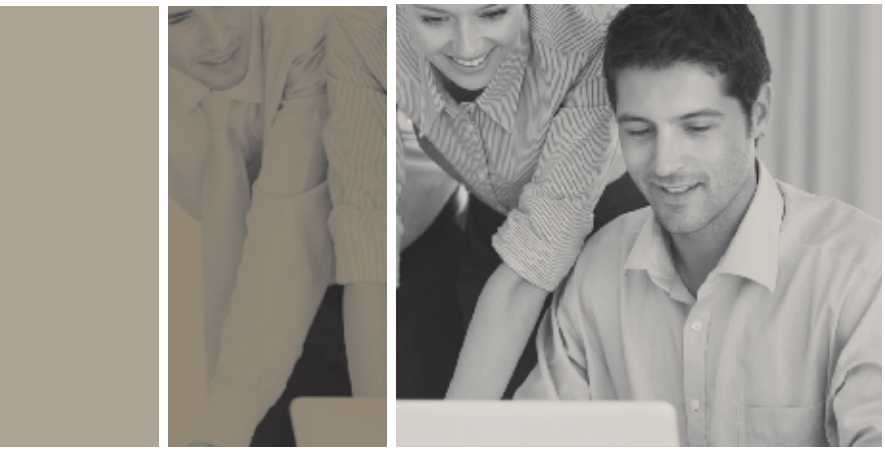

RECENT DEVELOPMENTS ON POLICYHOLDER DIVIDEND ACCRUALS

By Peter H. Winslow and Brion D. Graber

As part of the Deficit Reduction Act of 1984 (the "1984 Act"), life insurance companies are required to use the accrual method of accounting for tax purposes (except with respect to insurance reserves).[1] Previously, life insurance companies were able to claim a deduction for reserves for policyholder dividends that were to be paid in the following tax year.[2] Following the changes made by the 1984 Act, however, life insurance companies are now required to satisfy the same conditions as other accrual method taxpayers before they can claim deductions for policyholder dividends. For unpaid policyholder dividends on a single contract attributable to the current policy year, the Internal Revenue Service's ("IRS's") position is that the accrual standard is not met as of year-end because, under the terms of the policy, the company is not required to pay a dividend if the policy is surrendered prior to the anniversary date.

In general, an accrual method taxpayer may not claim a deduction for a liability it owes until the "all-events test" is met and "economic performance" occurs with respect to the item.[3] The all-events test requires that all events have occurred that determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.[4] When economic performance occurs depends on the nature of the liability. If the liability of the taxpayer is to pay a rebate or refund, for example, economic performance generally is treated as occurring when the rebate or refund is paid to the person to whom it is owed.[5] Similarly, when the regulations do not specify the time that economic performance occurs for a particular item, the default rule is that the deduction is deferred until the time that payment is made to the person to whom the liability is owed.[6] Under the recurring item exception, however, an item is treated as incurred, and thus deductible, in a taxable year if: (1) the all-events test is met; (2) economic performance with respect to the liability occurs within the first 8½ months following the close of that taxable year (or, if earlier, before the taxpayer files a timely (including extensions) return for that taxable year); (3) the liability is recurring in nature; (4) the amount of the liability is not material or the accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than if the liability were accrued in the taxable year in which economic performance occurs; and (5) the liability is a type eligible for the recurring item exception.[7] A rebate or refund is a type of liability eligible for the recurring item exception.[8]

In response to the change in law in the 1984 Act, many companies that issue participating policies changed their business practices so that they could argue that policyholder dividends satisfy the accrual standards as of year-end. A typical way to accomplish this objective is for the board of directors, shortly before the end of the year, to adopt a resolution in which it declares unpaid policyholder dividends, specifies formulae on which policyholder dividends will be paid in the following year, and provides that the company is making an irrevocable commitment to pay dividends in all events of no less than a stated aggregate amount with respect to the entire block of post-1983 policies in force on their next anniversary date ("aggregate policyholder dividends").[9] The board's actions, in combination with the terms of the policies, establish the fact of the company's liability and the amount of that liability. To the extent the aggregate policyholder dividends are paid within the first 8½ months following the close of the taxable year in which they are declared, they meet the requirements of the recurring item exception as a rebate or refund of a portion of the premiums paid with respect to the policies. Thus, the company might claim a deduction for an accrued liability for the aggregate amount of policyholder dividends paid within the 8½-month period.

The IRS has challenged life insurance companies' tax treatment of aggregate policyholder dividends involving facts similar to those described above, and commonly has made four arguments.[10] First, the IRS, relying on Revenue Ruling 76-345,[11] has argued that the life insurance company has not established the fact of the liability because the company cannot identify the specific policies with respect to which it actually will pay or credit a policyholder dividend, nor can it

identify the specific amount of any such policy payment or credit. Rather, the life insurance company knows only that it eventually will pay no less than a certain aggregate amount to some portion of the current policyholders. Second, the IRS argues that the unilateral action of a life insurance company's board of directors in declaring aggregate policyholder dividends is unenforceable and thus does not represent a genuine obligation of the company for which a deduction is available. Instead, according to the IRS, the relationship between the life insurance company and the policyholders is governed exclusively by the policy terms, and only when the policy requires the company to pay a policyholder dividend (generally not until the policy anniversary date) does the company have a binding obligation. In other words, the IRS contends that the company's board resolution can be reversed. Third, the IRS argues that economic performance has not occurred, because the aggregate policyholder dividends have not yet been paid, and the recurring item exception is unavailable, because the aggregate policyholder dividends are "other liabilities," which are ineligible for the recurring item exception. According to the IRS, the aggregate policyholder dividends do not constitute rebates or refunds, which are eligible for the recurring item exception, because they are not merely a return of premiums but instead at least partially include a return on investment earnings. Finally, in more recent audits, the IRS has argued that the board resolution should be ignored because it lacks economic substance and a business purpose.

REVENUE RULING 2011-29[12]

This recent Revenue Ruling now appears to preclude the IRS from making the first argument. In the Revenue Ruling, the IRS held that a taxpayer could establish "the fact of the liability" under the all-events test for bonuses payable to a group of employees even though the taxpayer does not know the identity of any particular bonus recipient or the amount payable to any particular recipient until after the end of the taxable year. This holding represents a reversal of the IRS's previously long-held position, as expressed in Revenue Ruling 76-345, that the all-events test cannot be satisfied if a taxpayer's liability is fixed and certain only with respect to a group as a whole and not with respect to individual participants in the plan to which the liability relates. Accordingly, Revenue Ruling 2011-29 revoked Revenue Ruling 76-345.

The position expressed in Revenue Ruling 2011-29 is consistent with well-established case law. Those cases include *United States v. Hughes Properties, Inc.*,[13] in which the Supreme Court held that the taxpayer was entitled to a deduction at the end of its taxable year for the amount it was guaranteed to pay in its progressive slot machines notwithstanding that the eventual winner's identity and the time at which the jackpot would be paid were unknown, and *Washington Post Co. v. United States*,[14] in which the Court of Claims held the taxpayer could deduct amounts accrued to its dealer profit-sharing plan that it was irrevocably bound to pay, even though the ultimate recipients of the payments and the time of actual payout were indeterminate. Revenue Ruling 76-345 was issued in response to *Washington Post* and served to announce that the IRS would not follow that case's holding in similar circumstances.

Revenue Ruling 2011-29 is significant for life insurance companies that have claimed deductions for aggregate policyholder dividends. The Revenue Ruling essentially eliminates the first of the four arguments discussed above that the IRS has historically made in cases in which it has challenged a life insurance company's tax treatment of aggregate policyholder dividends. The IRS effectively has conceded that it is not necessary to identify specific policies, or a particular amount to be paid with respect to a specific policy, to satisfy the all-events test.

NEW YORK LIFE[15]—DECIDED APRIL 19, 2011

In this case, New York Life sought to deduct policyholder dividends in the year prior to the one in which they were actually paid. However, the facts of this case differ from the "typical" facts described above. Here, New York Life's board did not make an irrevocable guarantee to pay aggregate policyholder dividends in all events of no less than a stated amount. Instead, New York Life claimed deductions for two different types of dividends. The first were amounts actually credited to policyholder accounts in December that were paid on the policies' anniversary dates in January of the following year ("January dividends"). The second was the amount that New York Life estimated it would pay in the first 8½ months of the following year equal to the lesser of an annual dividend or termination dividend on each policy. In a relatively brief decision, the District Court for the Southern District of New York granted the government's motion to dismiss New York Life's com-

This recent Revenue Ruling now appears to preclude the IRS from making the first argument.

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plaint for failure to state a claim on which relief could be granted.

According to the Court, with respect to the January dividends, New York Life did not allege facts that could plausibly support a conclusion it was required to pay dividends once they were credited to a policyholder account. Under the terms of the policies, New York Life was obligated to pay a policyholder dividend only if all premiums due had been paid and the policy was still in force on its anniversary date. The Court stated that if a policy was surrendered the day before its anniversary date, New York Life was not obligated to pay an annual dividend. New York Life's internal recordkeeping practices did not alter this result. The Court similarly held that the annual or termination dividends were contingent until the policy anniversary date. Thus, New York Life was not entitled to deduct the policyholder dividend amounts until they were paid.

The District Court's decision in this case is unusual because it was entered without even permitting New York Life to put on testimony that its consistent practice of crediting policyholder dividends before year-end or paying termination dividends created binding obligations on the company payable in all events through its course of conduct. New York Life has appealed, and it would not be surprising if the decision is reversed and remanded for further findings as to the nature of the company's obligations.

MASSMUTUAL[16]—DECIDED JAN. 30, 2012

In this eagerly awaited decision, the U.S. Court of Federal Claims considered the proper tax treatment of aggregate policyholder dividend guarantees of the type described above, and held that MassMutual was entitled to deduct them. For each year of the three years at issue, MassMutual's board of directors approved a dividend scale in October for the following year, and the board then adopted a resolution in December that "absolutely and irrevocably commits and guarantees that … it will pay or cause to be applied during [the following year], in all events, annual dividends for participating individual life and annuity policies issued after December 31, 1983, in an amount not less than [a specified sum]." MassMutual then paid policyholder dividends in the following year that exceeded the guaranteed amount. MassMutual claimed a deduction for the aggregate policyholder dividends declared by the board near the end of the year, that were guaranteed by the board to be paid in the following year, and that were actually paid by the company in the first 8½ months of the following year. The government denied MassMutual's claim for refund resulting from these claimed deductions, making all four of the arguments described above. In an exhaustive opinion, the Court rejected each argument.

The Court stated that resolution of the case revolved around two issues: whether the board resolutions fixed MassMutual's liability to pay the guaranteed policyholder dividend amounts and whether the policyholder dividends were rebates, refunds or similar payments that qualified for the recurring item exception. In response to the government's argument that MassMutual's liability was not fixed because MassMutual could not identify specific policies or amounts to be paid with respect to specific policies, the Court stated that "neither is fatal to the fixing of liability." The Court cited *Washington Post*,[17] *Hughes Properties*[18] and Revenue Ruling 2011-29[19] in support of its holding that the liability could be fixed even though the board resolutions providing the dividend guarantee did not identify specific policies or amounts.

The Court also rejected the government's argument that the board could potentially revoke the resolutions, and therefore the resolutions did not fix the fact of the liability. The Court noted that the government had not identified any case, statute or regulation requiring irrevocability as a necessary condition to fix the fact of a liability and that the government admitted at oral argument in the case that this was a weak argument.

The government presented related arguments that were similarly unconvincing to the Court. First, the government argued that the policyholders were not made aware of the board resolutions, and thus could not rely on them. According to the government, policyholder reliance might have limited the board resolutions' revocable nature, possibly rendering them enforceable. The Court noted, however, that one of the dividend guarantees was disclosed in an annual statement. In addition, the Court stated that, despite the government's assertion to the contrary, in at least some of the prior court cases permitting accrual of expenses following board resolutions there was no indication that knowledge of the resolution by the beneficiary was necessary for the liability to be fixed. Second, the government argued that MassMutual's regulators did not approve the dividend guarantees, would not have monitored MassMutual's compliance with the guarantees, and would have been unlikely to enforce the guarantees. As the Court stated, in each of the years at issue, MassMutual notified its

regulators of the dividend guarantees in advance or shortly after they were adopted and, at no time, did any regulator object to the guarantees. Moreover, no testimony or other evidence was presented indicating that the regulators lacked the authority to enforce the guarantees. Finally, the government argued that if MassMutual had been required to make a payment under the dividend guarantees, that payment would have violated the contribution principle of policyholder dividends and state laws because the post-1983 policyholders would then be receiving a disproportionate share of the divisible surplus in relation to their contributions. In rejecting this argument, the Court stated that a liability need not be legally enforceable to be fixed, a point which the government acknowledged.

In its discussion of whether the fact of MassMutual's liability was fixed, the Court addressed *New York Life*[20] in a footnote stating that New York Life's lawsuit was dismissed for failure to state a claim following a review of New York Life's complaint, while the facts in *MassMutual* were more fully developed following a trial and led to a different result. Surprisingly, the *MassMutual* Court did not explicitly distinguish the *New York Life* facts on the basis that New York Life did not adopt a board resolution guaranteeing payment of the dividends. Instead, the Court noted that *New York Life* relies on a Supreme Court case, *United States v. General Dynamics Corp.*,[21] which the Court did not find particularly relevant to resolving the *MassMutual* case. Specifically, the Court noted that *General Dynamics* involved a taxpayer's attempt to deduct an estimate of its obligation to pay for employee medical care when all of the claims had not yet been received or processed, while *MassMutual* involved the deduction of an amount for policyholder dividends to be paid in the subsequent year pursuant to a board resolution that fixed the liability in the taxable year the resolution was adopted.

Having determined that MassMutual's liability to pay the guaranteed policyholder dividends was fixed, the Court next addressed whether the policyholder dividends constituted rebates, refunds or similar payments under Treas. Reg. § 1.461-4(g)(3), and were thus eligible for the recurring item exception. The government argued that they were other liabilities ineligible for the exception because they included, at least in part, a return on investment earnings. The Court found this specific issue to be one of first impression and engaged in an extended examination of the Code, regulations, dictionary definitions, industry understanding, testimony, tax and industry treatises, legislative history, and cases addressing policyholder dividends in other contexts for guidance. Following this review, the Court found policyholder dividends are a return of premiums and thus constitute rebates, refunds or similar payments.

The final argument addressed by the Court was the government's contention that the board resolutions guaranteeing the dividends lacked economic substance and should be ignored. The Court rejected the government's argument. The Court held that the facts of this case were different from those in the economic substance cases on which the government sought to rely. Here, there was no dispute that the transactions giving rise to the deduction sought by MassMutual—the payment of policyholder dividends—were legitimate and should be respected; the only issue was at what time should MassMutual account for the deductions. In such circumstances, economic substance analysis has no place.

CONCLUSION

Revenue Ruling 2011-29, *New York Life* and *MassMutual* all provide recent guidance on the proper tax treatment of policyholder dividends. Following Revenue Ruling 2011-29 and the decision in *MassMutual*, one might expect that the government will no longer challenge a deduction for aggregate policyholder dividends based on the fact that individual recipients of the dividends cannot be identified as of year-end. As for the other three arguments the government has commonly raised, they were all rejected in *MassMutual*.

MassMutual has particular importance because the Court of Federal Claims is a court of national jurisdiction, so any taxpayer seeking a refund as the result of aggregate policyholder dividend accruals may file suit there, where the decision is persuasive authority. If the government appeals the *MassMutual* decision, the Court of Appeals for the Federal Circuit's decision would be binding authority on the Court of Federal Claims in any subsequent case presenting the same issue. Accordingly, a decision by the Federal Circuit affirming the lower court's decision would effectively end disputes over aggregate policyholder dividends, at least in cases involving substantially similar facts.

The Court held that the facts of this case were different from those in the economic substance cases on which the government sought to rely.

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A company that wants to strengthen its position with respect to its ability to deduct aggregate policyholder dividends might take certain steps suggested by *MassMutual*. Although the Court of Federal Claims did not find it critical to the resolution of the case, the government suggested that notifying policyholders of a board resolution guaranteeing aggregate policyholder dividends may blunt an argument that the guarantee is somehow revocable and, therefore, not fixed. In addition, a company may want to communicate with its regulators in advance of adopting the board resolution and secure the regulators' approval. It may also be useful to have regulators clarify that they have the authority to enforce any such guarantee and will do so if it becomes necessary.

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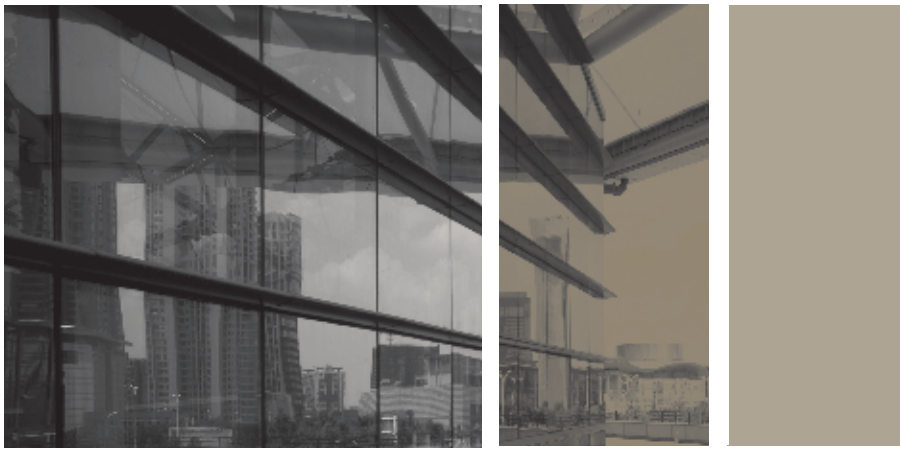
END NOTES

1 I.R.C. § 811(a).
2 Former I.R.C. § 811(b).
3 I.R.C. § 461(h)(1).
4 I.R.C. § 461(h)(4); Treas. Reg. § 1.461-1(a)(2)(i).
5 Treas. Reg. § 1.461-4(g)(3).
6 Treas. Reg. § 1.461-4(g)(7).
7 I.R.C. § 461(h)(3); Treas. Reg. § 1.461-5.
8 Treas. Reg. § 1.461-5(a), (c).
9 The board resolution generally applies only to policies issued after 1983 to avoid unfavorable tax consequences. Specifically, the 1984 Act included a transition rule providing that the change from a reserve to an accrual method of accounting for policyholder dividends was not to be treated as a change in method of accounting. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 216(b)(1), 98 Stat. 758. As a result of this "fresh start," companies did not have to recognize any income or loss with respect to amounts in existing policyholder dividend reserves. The fresh-start benefit is recaptured, however, if a company changes its business practices to accelerate policyholder dividend deductions and thereby obtain tax benefits beyond those provided by the fresh start. The recapture provision does not apply to policies issued after 1983. I.R.C. § 808(f)(7).
10 *See, e.g.*, *Massachusetts Mutual Life Insur. Co. v. United States*, No. 07-648T (Fed. Cl. Jan. 30, 2012); Memorandum of Law in Support of the United States of America's Motion to Dismiss, *New York Life Insur. Co. v. United States*, 780 F. Supp. 2d 324 (S.D.N.Y. 2011) (No. 10 Civ. 4701 (VM)).
11 1976-2 C.B. 134.
12 2011-49 I.R.B. 824.
13 476 U.S. 593 (1986).
14 405 F.2d 1279 (Ct. Cl. 1969).
15 *New York Life Insur. Co. v. United States*, 780 F. Supp. 2d 324 (S.D.N.Y. 2011).
16 *Massachusetts Mutual Life Insur. Co. v. United States*, No. 07-648T (Fed. Cl. Jan. 30, 2012).
17 405 F.2d 1279 (Ct. Cl. 1969).
18 476 U.S. 593 (1986).
19 2011-49 I.R.B. 824.
20 780 F. Supp. 2d 324 (S.D.N.Y. 2011).
21 476 U.S. 239 (1987).

PROPOSED REGULATION TO ACCOMMODATE LONGEVITY ANNUITIES IN RETIREMENT PLANS



By Christian DesRochers

BACKGROUND

In September 2009, the Internal Revenue Service (IRS) released a private letter ruling (PLR 200939018, June 18, 2009) addressing a contract in which the right to receive annuity payments and otherwise access a contract's cash value is contingent upon the annuitant living to a specified age. The ruling held that the contract was an annuity contract for purposes of section 72 of the Internal Revenue Code (the "Code"). While these types of pure deferred annuity contracts, currently known as "longevity annuities" or "longevity insurance" have long been viewed by the insurance industry as a type of annuity contract, there was a question as to whether a contract that lacked a cash value should be treated as an annuity contract for tax purposes. Ruling in the affirmative, PLR 200939018 provided a clarification from the IRS confirming the treatment of longevity annuities as a form of annuity for tax purposes, despite the absence of a cash value during the deferral period.[1]

However, the issue of the treatment of longevity annuities under the Required Minimum Distribution (RMD)[2] rules remained unsettled and the regulations applying the RMD rules have had the practical effect of limiting the offering of longevity annuities in qualified plans and traditional IRAs while the issue remained unsettled. RMDs generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 70½ years of age or, if later, the year in which he or she retires.[3] The rules require that a portion of traditional IRA and employer-sponsored plan assets be distributed over the life or life expectancy of a plan participant after that time. The rules were put in place to ensure that retirement funds are distributed rather than used as a way to avoid estate taxes.

The February 2012 report from the President's Council of Economic Advisors, "Supporting Retirement for American Families" (the "CEA Report"), observed that while the current market for longevity annuities is very small, interest in the product has been increasing. Because longevity annuities typically are purchased at or near retirement but do not begin paying benefits until considerably later, they can be offered at a fraction of the cost of annuities that pay immediate benefits, thus allowing retirees protection against the risks of extended longevity at an affordable price, while also allowing them to retain most of their wealth. The proposed regulations define a class of products knows as "qualifying longevity annuity contracts" (QLACs), which are excluded from the account balance used to determine required minimum distributions. By exempting longevity annuities (up to a specified limit) from the RMD rules, it is hoped that it will provide individuals under defined-contribution plans the option to use an "affordable" portion of their account balance to purchase a longevity annuity. The proposed regulations apply to tax-qualified defined-contribution plans under section 401(a), section 403(b), individual retirement annuities and accounts (IRAs) under section 408, and eligible governmental section 457 plans.

DEFINITION OF A QLAC

Under the proposed regulations, a QLAC is defined as "an annuity contract (that is not a variable contract under section 817, equity-indexed contract, or similar contract) that is purchased from an insurance company for an employee." However, a QLAC may also be purchased in an IRA, subject to rules discussed below.

The proposed regulations provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under the plan on a given date may not exceed the lesser of a dollar or a percentage limitation. The proposed regulations prescribe rules for applying these limitations to participants who purchase multiple contracts or who make multiple premium payments for the same contract. Under the dollar limitation, the aggregate amount of the premiums paid for QLACs under a plan may not exceed $100,000. Under the percentage limitation, the amount of the premiums paid for

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a contract under the plan may not exceed an amount equal to 25 percent of the employee's account balance on the date of payment. However, if, on or before the date of a premium payment, an employee has paid premiums for the same contract or for any other contract that is intended to be a QLAC and that is held or purchased for the employee under the plan, the maximum amount under the 25 percent limit is reduced by the amount of those other payments.

The proposed regulations would permit a QLAC to allow a participant to elect an earlier annuity starting date than the specified annuity starting date. For example, if the specified annuity starting date under a contract were the date on which a participant attains age 85, the contract would not fail to be a QLAC solely because it allows the participant to commence distributions at an earlier date. On the other hand, these rules would not require a QLAC to provide an option to commence distributions before the specified annuity starting date, so that a QLAC could provide that distributions must commence only at the specified annuity starting date. The definition of a QLAC is intended to promote affordability, focusing on maximizing the annual annuity payment relative to the premium. As a result, under a QLAC, the only benefit permitted to be paid after the employee's death is a life annuity, payable to a designated beneficiary that meets certain requirements. Thus, for example, a contract that provides a distribution form with a period certain or a refund of premiums in the case of an employee's death would not be a QLAC, as these types of benefits would add to the cost of the annuity, contrary to the purpose of providing cost-effective lifetime income to employees and their beneficiaries. Following this logic, the proposed regulations provide that if the sole beneficiary of an employee under the contract is the employee's surviving spouse, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse that does not exceed 100 percent of the annuity payment payable to the employee.

Under the proposed regulations, a QLAC would exclude variable contracts under section 817, equity-indexed contracts, or similar products, because they are seen as inconsistent with the purpose of a QLAC, which is to provide a predictable stream of lifetime income. In addition, the proposed regulation notes that exposure to equity-based returns is available through control over the remaining portion of the account balance so that a participant can achieve adequate diversification. The proposed regulations also provide that, in order to be a QLAC, consistent with the affordability concept, the contract is not permitted to make available any commutation benefit, cash surrender value, or other similar feature. As in the case of the limitations on benefits payable after death, these limitations would allow an annuity contract to maximize the annuity payments that are made while a participant or beneficiary is alive. In addition, the proposed regulation comments that having a limited set of options available to purchasers would make these contracts more readily understandable and enhance product comparability. The proposed regulations provide that a contract must be specifically identified as a QLAC at issue to ensure that the issuer, participant, plan sponsor and IRS know that the rules applicable to QLACs apply.

APPLICABILITY OF THE QLAC RULES

The QLAC rules apply to the purchase of longevity annuity contracts under tax-qualified defined-contribution plans under section 401(a) of the Code, section 403(b) plans, individual retirement annuities and accounts (IRAs) under section 408, and eligible governmental section 457 plans.

For an IRA, the QLAC requirements are applied in the aggregate. Consistent with the general limitations, the proposed regulations provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under an IRA on a given date may not exceed $100,000. If, on or before the date of a premium payment, a participant has paid premiums for the same contract or for any other contract that is intended to be a QLAC and that is purchased for the participant under the IRA or under any other IRA, plan or annuity, the $100,000 limit is reduced by the amount of those other premium payments. The proposed regulations also provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under an IRA on a given date generally may not exceed 25 percent of a participant's IRA account balances. Consistent with the rule under which a required minimum distribution from an IRA could be satisfied by a distribution from another IRA (applied separately to traditional IRAs and Roth IRAs), the proposed regulations would allow a QLAC that could be purchased under an IRA within these limitations to be purchased instead under another IRA. Specifically, the amount of the premiums paid for the contract under an IRA may not exceed an amount equal to 25 percent of the sum of the account balances (as of Dec. 31 of the calendar year before the calendar year in which a premium is paid) of the IRAs (other than Roth IRAs) that an individual holds as the

IRA owner. If, on or before the date of a premium payment, an individual has paid other premiums for the same contract or for any other contract that is intended to be a QLAC and that is held or purchased for the individual under his or her IRAs, the premium payment cannot exceed the amount determined to be 25 percent of the individual's IRA account balances, reduced by the amount of those other premiums.

Under the proposed regulations, an annuity purchased under a Roth IRA would not be treated as a QLAC. The proposed regulations would not preclude the use of assets in a Roth IRA to purchase a longevity annuity contract, nor would such a contract be subject to the same restrictions as a QLAC. For example, a longevity annuity contract purchased using assets of a Roth IRA could have an annuity starting date that is later than age 85 and offer features, such as a cash surrender right, that are not permitted under a QLAC. Although such a contract could not be excluded from the account balance used to determine required minimum distributions, this exclusion is not necessary because the required minimum distribution rules do not apply during the life of a Roth IRA owner. In addition, the dollar and percentage limitations on premiums that apply to a QLAC would not take into account premiums paid for a contract that is purchased or held under a Roth IRA, even if the contract satisfies the requirements to be a QLAC.

The proposed regulations apply the tax-qualified plan rules, instead of the IRA rules, to the purchase of a QLAC under a section 403(b) plan. For example, the 25 percent limitation on premiums would be separately determined for each section 403(b) plan in which an employee participates. The proposed regulations also provide that the tax-qualified plan rules relating to reliance on representations, rather than the IRA rules, apply to the purchase of a QLAC under a section 403(b) plan. These proposed regulations relating to the purchase of a QLAC under a tax-qualified defined-contribution plan would automatically apply to an eligible section 457(b) plan. However, the rule relating to QLACs is limited to eligible governmental section 457(b) plans. Because section 457(b)(6) requires that an eligible section 457(b) plan that is not a governmental plan be unfunded, the purchase of an annuity contract under such a plan would be inconsistent with this requirement. Although defined-benefit plans are subject to the minimum required distribution rules, they offer annuities which provide longevity protection. Because this protection is therefore already available, these proposed regulations would not apply to defined-benefit plans, but are limited to defined-contribution plan.

DISCLOSURE AND ANNUAL REPORTING REQUIREMENTS

Under the proposed regulations, the issuer of a QLAC would be required to create a report containing the following information about the QLAC:

1. A plain-language description of the dollar and percentage limitations on premiums;
2. The annuity starting date under the contract, and, if applicable, a description of the employee's ability to elect to commence payments before the annuity starting date;
3. The amount (or estimated amount) of the periodic annuity payment that is payable after the annuity starting date as a single life annuity (including, if an estimated amount, the assumed interest rate or rates used in making this determination), and a statement that there is no commutation benefit or right to surrender the contract in order to receive its cash value;
4. A statement of any death benefit payable under the contract, including any differences between benefits payable if the employee dies before the annuity starting date and benefits payable if the employee dies on or after the annuity starting date;
5. A description of the administrative procedures associated with an employee's elections under the contract, including deadlines, how to obtain forms, where to file forms, and the identity and contact information of a person from whom the employee may obtain additional information about the contract; and
6. Such other information that the Commissioner may require.

This report is not required to be filed with the IRS; however, each issuer required to create a report would be required to furnish to the individual in whose name the contract has been purchased a statement containing the information in the report. This statement must be furnished prior to or at the time of purchase. In addition, in order to avoid duplicating state law disclosure requirements, the statement would not be required to include information that the issuer has already provided to the employee in order to satisfy any applicable state disclosure law. The proposed regulations also prescribe annual reporting requirements under section 6047(d), which would require any person issu-

Under the proposed regulations, an annuity purchased under a Roth IRA would not be treated as a QLAC.

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ing any contract that states that it is intended to be a QLAC to file annual calendar-year reports and provide a statement to the individual in whose name the contract has been purchased regarding the status of the contract. The Commissioner will prescribe an applicable form and instructions for this purpose, which will contain the filing deadline and other information.

PROPOSED EFFECTIVE DATE

The proposed regulations regarding disclosure and reporting will be effective upon publication in the Federal Register of the Treasury decision adopting these rules as final regulations. Otherwise, these regulations are proposed to be effective for contracts purchased on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register and for determining required minimum distributions for distribution calendar years beginning on or after Jan. 1, 2013. Until regulations finalizing these proposed regulations are issued, taxpayers may not rely on the rules set forth in these proposed regulations (and the existing rules under section 401(a)(9) continue to apply).

CONCLUSION

As noted in the CEA Report, the proposed regulations are intended to "remove barriers that have prevented annuity providers and plans from offering the full array of such options, bringing valuable choice to retirement savers." With the status of the longevity annuities clarified under section 72, as well as under the RMD rules, it will be interesting to see if a market develops for longevity products. One commentator has observed that "[t]here appears to be universal agreement among financial economists and pension actuaries about the substantial social welfare benefits from payout (or immediate) annuity contracts. But the public and the media have yet to embrace this risk management instrument as being equally important as a well-diversified retirement portfolio of stock and bonds."[4] That is, the challenge that the life insurance industry faces is that, despite the arguments of the economists, the vast majority of retirees are unwilling to annuitize all of their assets. For a variety of reasons, the public has not embraced payout annuities as a financial solution to bridging the gap between accumulating wealth and guaranteeing retirement income payments, although many industry studies point to "consumers' reluctance to relinquish complete control over their assets by making such a purchase."[5] Whether the current initiative of the Obama administration to encourage the use of longevity products will succeed remains to be seen. However, it does provide the industry with an opportunity to offer a product solution to the challenge of providing sustainable retirement income.

The views expressed are those of the author and not of Ernst & Young LLP.

END NOTES

1. *See* McKeever and Garcia, "IRS Rules Longevity Contract is Annuity under Section 72," *TAXING TIMES* February 2010, 14.
2. The RMD rules apply to all employer-sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans and 457(b) plans. Stock bonus, pension and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to required minimum distribution rules under section 401(a)(9). The RMD rules also apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs and SIMPLE IRAs under sections 408(a)(6) and 408(b)(3). Deferred compensation plans for employees of tax-exempt organizations or state and local government employees are subject to required minimum distribution rules under section 457(d)(2).
3. However, if the retirement plan account is an IRA or the account owner is a 5 percent owner of the business sponsoring the retirement plan, the RMDs must begin once the account holder is age 70½, regardless of whether he or she is retired.
4. Moshe Milevsky, "Real Longevity Insurance with a Deductible: Introduction to Advanced Life Delayed Annuities (ALDA)," *North American Actuarial Journal*, Volume 9, No. 4, 109.
5. Rob Stone, "Longevity Insurance: An Answer to a Difficult Retirement Planning Question," *NAVA Outlook*, December 2006, 1.

IRS RULES THAT INSURANCE AGAINST DECLINE IN ASSET'S MARKET VALUE IS NOT INSURANCE FOR TAX PURPOSES

By Kevin M. Owens and Gregory L. Stephenson

In TAM 201149021, the Internal Revenue Service (the "Service") National Office has ruled that an insurance contract that insures against a decline in market value of assets leased to third parties is not an insurance contract for federal income tax purposes. Consequently, for these contracts, the Taxpayer must use § 451 and § 461 of the Code to determine the taxable year for which items of gross income are included and the taxable year for which deductions are taken.

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. In a trilogy of cases (*Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61 (1991); *The Harper Group v. Commissioner*, 96 T.C. 45 (1991); and *AMERCO v. Commissioner*, 96 T.C. 18 (1991)), the Tax Court stated that insurance involves "presence of insurance risk," "risk shifting and risk distributing," and "commonly accepted notions of insurance." In the TAM, the Service applied this three-part test and concluded that the arrangement is not insurance because it lacks insurance risk, it is not insurance in the commonly accepted sense, and it lacks risk distribution.

FACTS

The Taxpayer, a domestic property and casualty insurance company, enters into insurance contracts with unrelated parties (the "protected parties") that lease passenger vehicles, commercial equipment and commercial real estate (the "protected assets") to third parties. The protected parties enter into the contacts with Taxpayer to protect against a decline in the value of the protected assets over the term of the lease. Under the contracts, Taxpayer must pay a protected party an amount equal to the difference between the predicted residual value of the protected asset and the actual fair market value at the end of the lease term ("residual value payment").

The lease terms vary, and in some cases are as long as 25 years. Taxpayer issues the contracts in a form that is commonly accepted as insurance, with standard insurance policy provisions, and includes requirements that the protected party maintain an ownership interest in the protected asset from the time the contract is entered into until the end of the lease term. At the end of the lease term, the protected asset's fair market value is determined based on actual sales price, appraisal or other specified method. In consideration for Taxpayer's obligation, the protected parties make a payment to Taxpayer when the contract is signed.

There is no requirement for the protected party to show that the decrease in the final value of the protected asset resulted from any particular cause, and the contracts specifically list general economic downturns and advances in technology as potential factors in the contracts' non-exclusive list of possible causes. When a protected party submits a payment request to Taxpayer's claims department, Taxpayer verifies that the party has an ownership interest in the asset and that the terms and conditions of the contract have been satisfied.

INSURANCE RISK

The Service stated: "Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk." As support, the usual cases and rulings were cited for the proposition that the risk transferred must be more than a mere investment risk (*Helvering v. LeGierse*, 312 U.S. 531 (1941), *Securities and Exchange Commission v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), Rev. Rul. 89-96, 1989-2 C.B. 114, Rev. Rul. 68-27, 1968-1 C.B. 315, Rev. Rul. 2007-47 and 2007-30 C.B. 1277). The Service also stated that an insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. The Service, perhaps correctly, notes that a fortuitous event (such as a fire or accident) is at

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the heart of any contract of insurance. However, they again fail to acknowledge that fortuity can not only be relative to the occurrence of the event, but can also be relative to the magnitude of the loss.

The contracts at issue contemplate a projected decline in value over the term of the contract and then provide protection against the actual value at the end of the contract being lower than that projected value. The contracts generally do not protect against damage to the particular asset. Instead, the contracts protect against market forces that depress the value of the protected asset (and other similar assets) at the end of the term. The Service concluded that the contracts provided protection that the insured will receive less than its projected income from the protected asset at the end of the lease and that this type of risk is more akin to an investment risk than to an insurance risk.

INSURANCE IN THE COMMONLY ACCEPTED SENSE

In several decisions, the Tax Court has stated that for a contract to be treated as an insurance contract for federal tax purposes, the arrangement must be "insurance in its commonly accepted sense." However, neither the Tax Court nor any other authority has provided a thorough explanation of what is meant by insurance in its commonly accepted sense. In the TAM, the Service, citing no precedent or legal basis for doing so, provided its interpretation of the phrase "insurance in its commonly accepted sense" by initially stating that the phrase does not mean that all products sold by insurance companies are insurance policies. The tax treatment of a product at issue should be decided by legal relationships and not by the number of product sellers or the amount of product sales. The fact that other companies offer contracts similar to those at issue in this case does not change their conclusion.

After an analysis of known insurance products, the Service concluded that a factor found in insurance contracts that weighs heavily in this case is that insurance policies protect against damage or impairment to an asset or income from an asset caused by a casualty event. With respect to the residual value insurance, the Service concluded that the insurance company's obligation did not arise because of an event that damages or impairs the protected asset or its income stream. The contracts ensure that the projected income from the sale of the assets will not be reduced because of market forces. The risk is the unexpected market forces, but the occurrence of these events is not the casualty event. Unfavorable market changes may occur during the term of the contract without creating any liability. The event that triggers the insurance company's liability is the termination of the contract. Then, after noting all of the contract's features that are commonly found in insurance policies, and without citing any legal precedent, the Service concluded that the contracts are not insurance in the commonly accepted sense because contract termination, apparently even when coupled with the occurrence of the unexpected market forces for which protection is sought, does not give rise to a casualty event.

RISK DISTRIBUTION

Risk distribution is frequently cited as a fundamental requirement for insurance. However, there is little authority that discusses what is meant by risk distribution. Generally, risk distribution has been described as requiring both a large number of risks and risks that are independent of one another. The Service addressed interdependent risks in Rev. Rul. 60-275, 1960-2 C.B. 43, where a number of insureds pooled their premiums for coverage of assets all subject to the same flood risk. The Service concluded that risk distribution was not present; reasoning, in part, that a major flood would affect all properties involved because all properties were located in the same flood basin. The ruling stated that there was little likelihood that the subscribers would share any risk.

The TAM extrapolated from the very localized flood basin situation to a nationwide venue and without giving much weight to the myriad asset-specific, class of asset, local and regional factors impacting value, concluded that the better factual argument was that the risks insured under the contracts were interdependent. This conclusion was based on the assertion that the insurance company could not sufficiently utilize the law of large numbers to distribute its risk among the protected assets to achieve risk distribution in its commonly defined sense. No legal, actuarial or statistical basis or methodology was referenced or described as either support for the conclusion or as providing any guidance for the application of this approach.

IMPLICATIONS OF THE RULING

The TAM addresses an issue for which there is little, if any, guidance that is on point. This is the first, and likely not the last, attempt by the Service to distinguish between contracts that transfer an economic risk of loss that they wish to treat as insurance contracts for federal tax purposes and those that

they do not wish to treat as insurance contracts for federal tax purposes. While the TAM addresses residual value insurance contracts, the type of analysis used by the Service could have broader implications.

Having concluded that the contracts are not insurance contracts, the Service states, without analysis, that the premiums received by the insurance company are subject to §451 income recognition rules, and losses paid by the insurance company are subject to the §461 all-events and economic performance rules. Thus, with no discussion of the proper matching of income and expense, the Service has created a situation where the "premium" could be fully taken into income up front and the related expense up to 25 years later. The Service did not discuss other possible accounting methods that could be applied to the transaction; for example, whether the contracts could be accounted for using the tax accounting rules applicable to option contracts.

The views expressed are those of the authors and not of Ernst & Young LLP.

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COMMON SENSE, INSURANCE IN THE COMMONLY ACCEPTED SENSE, AND TAM 201149021

By David A. Schenck, Surjya Mitra and Mark S. Smith

OVERVIEW

The federal income tax case law's definition of insurance is well-established, if not consistently applied. In order for an arrangement to qualify as insurance, the arrangement must (i) involve an insurance risk, (ii) involve both risk shifting and risk distribution, and (iii) constitute insurance in the commonly accepted sense.[1] Beginning in the 1960s, the Internal Revenue Service (IRS) devoted extraordinary resources to the second prong of this test, seeking to disqualify as non-insurance those arrangements that, in the IRS view, lacked risk shifting or risk distribution.[2] Those efforts met with limited success, and in the first decade of the 21st century the IRS generally retreated on how the requirements of risk shifting and risk distribution would be applied in the context of related parties.[3] The IRS did not retreat more generally, however, on other issues that arise in the context of unrelated parties. In addition, the IRS's acknowledgement of its litigation losses on risk shifting and risk distributing necessarily puts pressure on the application of the lesser-developed elements of the definition of insurance.

Given this background, it is not surprising that, in TAM 201149021, the IRS took another tack in contesting purported insurance arrangements, concluding that residual value insurance did not qualify as insurance for federal income tax purposes. The authors argue that the standard for what is "insurance in the commonly accepted sense" was misapplied in the TAM, and that, in any event, the accounting regime imposed by the IRS produces a significant distortion of the taxpayer's income.

BACKGROUND

The characterization of an arrangement as "insurance" has significant consequences for the protection buyer (the policyholder) and the protection seller (the insurer). For the protection buyer, an insurance premium paid is generally deductible, even though economically the premium may be more akin to a prepayment of amounts that otherwise would not yet be deductible because they do not yet meet the all-events and economic performance requirements of section 461. For the protection seller, premium income is generally recognized over the period of coverage, and losses incurred are generally deducted on a reserve basis, even though payment might not be made for years. Because insurance premiums are deductible, whereas amounts set aside for self-insurance are not deductible, the IRS has historically fought to prevent the characterization of arrangements as insurance for federal income tax purposes, except for the most straightforward, commercially common arrangements.

The Internal Revenue Code Defines the Term "Insurance Company," but Does Not Define What Is an Insurance Contract

Section 816(a) defines the term "life insurance company" as an insurance company that is engaged in the business of issuing life insurance and annuity contracts or noncancelable accident and health insurance contracts, if its life insurance reserves comprise more than 50 percent of its total reserves. For this purpose, a company is an insurance company if more than half the business of the company during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.[4] Under section 831(c), the same definition applies in the case of a non-life insurance company.

Although the definition of insurance company requires that a taxpayer be in the business of issuing insurance or annuity contracts, the Internal Revenue Code (the "Code") does not define the term "insurance contract." Rather, the analysis of whether an arrangement is an insurance contract for federal income tax purposes generally depends on the application of federal income tax case law.

This analysis typically begins with a citation to *Helvering v. LeGierse*, 312 U.S. 531 (1943). In *LeGierse*, an elderly woman purchased a life insurance policy, naming her daugh-

ter as beneficiary; however, before accepting the policy, the life insurance company required the elderly woman to enter into a lifetime annuity contract. Based on the interdependency of the life insurance and annuity policies, the Supreme Court determined that the insurance company effectively held offsetting positions, thus neutralizing its "insurance" risk. Consequently, a true insurance arrangement did not exist between the policyholder and the insurance company. In defining "insurance," the Supreme Court noted:

> We think … that the amounts must be received as the result of a transaction which involved an actual "insurance risk" at the time the transaction was executed. Historically and commonly insurance involves risk-shifting and risk-distributing…. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators.

After the Supreme Court's decision in *LeGierse*, other courts (generally citing *LeGierse* and generally in the context of life insurance) applied a similar standard.[5]

Historically, the IRS Has Attempted To Limit the Definition of "Insurance" Administratively

As early as 1960, the IRS examined a purported insurance arrangement among policyholders who owned real estate in the same floodplain. The ruling, Rev. Rul. 60-275, 1960-2 C.B. 43, concluded the arrangement lacked the requisite risk distribution, because a single flood would cause losses for all policyholders. Thus, the risks were not statistically independent.[6]

In the mid-1970s, the IRS stepped up its activity in the area and in Rev. Rul. 77-316, 1977-2 C.B. 53, for the first time pronounced the "economic family theory." The ruling discussed situations where purported insurance premiums are paid by a domestic parent corporation and its domestic subsidiaries to a wholly owned foreign "insurance" subsidiary of the parent under an insurance arrangement. The ruling concluded that the foreign subsidiary was not an insurance company as the arrangement may not be respected as insurance for tax purposes because it is within the same economic family. The basic theory of the IRS, which came to be known as "the economic family theory," was that there is no economic shifting or distributing of risks of loss if the insurer and insureds are economically related.

By 2000 and 2001, the Exam function of the IRS was dutifully and consistently citing Rev. Rul. 77-316 and disallowing the insurance characterization of arrangements between a taxpayer and other members of the same economic family. Appeals was dutifully and consistently evaluating the hazards of litigating these cases, and in many cases signing off on full concessions.[7]

No court, however, fully accepted the economic family theory articulated in Rev. Rul. 77-316. In 2001, the IRS formally abandoned the economic family theory and promised to apply a facts and circumstances test to determine whether an arrangement that purported to qualify as insurance for federal income tax purposes in fact met the standards of the relevant case law.[8]

Since 2001, the IRS has provided a series of helpful rulings that are best described as safe harbors for determining whether an arrangement among related parties has the requisite risk shifting and risk distribution to qualify as insurance. In Rev. Rul. 2002-89, 2002-2 C.B. 984, the IRS analyzed arrangements between a domestic parent corporation and its wholly owned subsidiary that constituted insurance. The ruling concludes that the amounts paid by a domestic parent corporation to its wholly owned insurance subsidiary are not deductible as insurance premiums if the parent's premiums are not sufficiently pooled with those of unrelated parties. The ruling also effectively provides a safe harbor under which a parent-subsidiary arrangement will be respected as insurance if at least 50 percent of the insurer's business represents unrelated risks. In Rev. Rul. 2002-90, 2002-2 C.B. 985, the IRS concluded that payments for professional liability coverage by a number of operating subsidiaries to an insurance subsidiary of a common parent constituted insurance, as long as no single operating subsidiary contributed more than 15 percent or less than 5 percent of the total risks assumed by the insurance subsidiary. The ruling also effectively provides a safe harbor under which arrangements among an insurer and at least 12 sibling operating companies may constitute insurance. In Rev. Rul. 2002-91, 2002-2 C.B. 991, the IRS described circumstances under which amounts paid to a group captive of unrelated insureds are deductible as insurance premiums and in which the group captive qualifies as an insurance company.

In addition, the IRS has elaborated on its position that an arrangement cannot qualify as insurance if only the risks of a single policyholder are pooled. Rev. Rul. 2005-40, 2005-2

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C.B. 4, sets forth four circumstances under which an operating company with a large number of statistically independent, homogeneous risks entered into an "insurance contract" with an unrelated, intended insurance company. In Situation 1, the arrangement did not qualify as insurance because the insurer did not enter into contracts with any other policyholders; in the view of the IRS, risk distribution was not present. Consistently, in Situation 2, the arrangement did not qualify as insurance because 90 percent of the insurer's business was that of a single policyholder. In Situation 3, insurance contracts entered into with 12 unrelated single member LLCs did not qualify as insurance contracts because the single member LLCs were disregarded for federal income tax purposes and all treated as a single entity. Situation 4 was the same as Situation 3, except that the single member LLCs were not disregarded, and the arrangements accordingly had sufficient risk distribution to qualify as insurance.

Rev. Rul. 2005-40 was followed up with an assurance in Rev. Rul. 2009-26, 2009-2 C.B. 366, that the IRS would not apply its single-insured position in the context of a reinsurer that enters into a single contract with a single ceding company, provided the underlying block of business represents a sufficiently large number of unrelated primary insureds.[9]

Insurance Risk

One of the conditions of insurance is that the risk transferred must constitute an insurance risk. There is, however, no tax definition of insurance risk. The courts and the IRS have thus either pronounced their own independent standards or turned to economic and legal definitions.

In *Allied Fidelity Corp. v. Commissioner*, 66 T.C. 1068, 1074 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978), the Tax Court wrote that insurance risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

In *AMERCO v. Commissioner*, the Ninth Circuit stated:

> The insurance risk is the possibility that a particular event for which an insured will be held liable will occur. Of course, from the standpoint of the insured there can be no profit from that risk. The only possible outcomes are loss or no loss. It is that risk which must be transferred to the insurer if true insurance is to be involved. Speculative risk, on the other hand, is merely investment risk, and it can produce profit or loss.

In a Litigation Guideline Memorandum,[10] the IRS stated:

> Businesses face hazards that expose them to adverse but uncertain financial consequences. These hazards are referred to as pure risks or insurable risks (in contrast to investment or speculative risks). A "pure risk" is defined by one of the government's trial experts, Dr. Irving H. Plotkin, as a risk that can only have bad or neutral results. See The Harper Group v. Commissioner, T.C. Docket No. 33761-85, Report of Irving H. Plotkin, p.7. An example of a pure risk is a fire or accident. A speculative or investment risk can have good, bad, or neutral results. An example of a speculative risk is the risk of whether a profit or loss will be generated from the conduct of a business or by taking a position on foreign currency. The insurance industry generally does not offer products to manage these types of risks. R. Riegel, J. Miller, & C. Williams, Insurance Principles and Practices: Property and Liability 2 (6th ed. 1976). Only a pure risk is an insurable risk (also known as an insurable interest). When this type of risk is transferred to an insurance company, the insured has relieved itself of the financial uncertainty concerning the consequences of an event. In the hands of the insurer, however, the pure risk of the insured has become an investment risk; will the loss cost more or less than the accumulated premiums and investment earnings?

Note, it is unclear how the IRS believes this analysis distinguishes investment risk from insurance risk. For example, one would expect an insurer to undertake the same comparison of expected loss versus premiums and investment earnings when evaluating an arrangement that clearly qualifies as insurance.

In Rev. Rul. 89-96, 1989-2 C.B. 114, the IRS denied the insurance characterization of a contract on the basis that merely investment risk was transferred to the insurer. The ruling considers a situation where a catastrophe occurs in June 1987, imposing a liability on the taxpayer "substantially in excess" of $130. The taxpayer has insurance coverage of $30. In July 1987, the taxpayer purchases additional "insurance" of $100. The ruling concludes that the transaction involved only investment risk and not insurance risk. The IRS stated that there are two elements to the ruling which eliminate insurance

risk. First, the loss has occurred, and second the anticipated liability ($130+) exceeds the total coverage ($30 + $100). Since the anticipated liability is substantially in excess of the total coverage, the full amount of the coverage will be paid. Thus, there is no risk regarding the amount payable, but only the period over which it will be paid. The ruling concludes that the risk elements borne by the insurance company were a timing risk (that the $100x would have to be paid out earlier than anticipated) and an investment risk (that the actual investment yield would be lower than forecast). The ruling concludes that these risks are not insurance risks.

It is also commonly understood that insurance is the mechanism to manage the risk of loss from fortuitous events. APPLEMAN ON INSURANCE 2d, section 1.4 provides

> Fortuity is another key element in determining what constitutes insurance for purposes of legal classification. It would be foolhardy for insurance companies to sell insurance that would pay for losses strictly within an insured's control…. This is the point where the concept of fortuity comes into play. Insurance is designed to cover the unforeseen or at least unintentional damages arising from risks encountered in life and business: injuries and damages caused by negligence and other similar conduct where the insured stands to sustain a real and palpable loss (generally pecuniary) as a result of the event for which the insurance has been purchased.

The IRS thus followed up on Rev. Rul. 89-96 with Rev. Rul. 2007-47, 2007-2 C.B. 127, which concludes that an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk for purposes of determining (i) whether the amount paid for the arrangement is deductible as an insurance premium and (ii) whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of subchapter L of the Code. In that ruling, the costs at issue were environmental cleanup costs that were certain to be incurred in the future, but uncertain as to timing and amount. Important to the analysis of Rev. Rul. 2007-47 was a premium amount and a policy limit that established that, economically, the "premium" paid under the arrangement represented a prefunding of known future costs.

The facts of Rev. Rul. 2007-47 do not include a risk transfer analysis of the sort often undertaken for regulatory and accounting purposes. The insurance risk requirement, however, also means that the insured must have exposure to an actual, economic loss. In *Group Life & Health Ins. Co. v. Royal Drug Co*., 440 U.S. 205, 211 (1979), the Court explained that risk shifting entails the transfer of the impact of a potential economic loss from the insured to the insurer. If the insured has shifted its risk to the insurer, then a loss does not affect the insured because the loss is offset by the proceeds of an insurance payment. Similarly, in *Epmeier v. United States*, 199 F.2d 508, 509-10 (7th Cir. 1952), the term "insurance contract" was defined as "a contract whereby, for an adequate consideration, one party undertakes to indemnify another against loss from certain specified contingencies or peril…. [I]t is contractual security against possible anticipated loss."

Insurance in the Commonly Accepted Sense

The analysis of the third prong of the traditional insurance analysis—insurance in the commonly accepted sense—is less developed than the other prongs of the traditional three-prong insurance analysis.

On the same day it decided *AMERCO* , articulating the familiar three-prong standard for what constitutes insurance, the Tax Court also decided *The Harper Group v. Commissioner,* 96 T.C. 45, 58 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992). In *The Harper Group*, the court elaborated on what constituted insurance in the commonly accepted sense. Specifically, the court enumerated the following factors to support a conclusion that arrangements entered into by an international shipping firm qualified as insurance: (1) the insurer was both organized and operated as an insurance company; (2) the insurer was regulated as an insurance company by the relevant local regulator; (3) the premiums under the arrangements were the result of arms-length transactions; and (4) the arrangements at issue were valid and binding. Apart from these factors, there is little guidance about what constitutes insurance in the commonly accepted sense, and the IRS's efforts to equate this with a "fortuity" requirement and apply its independent notion of what satisfies this have met with some controversy.[11]

It is also commonly understood that insurance is the mechanism to manage the risk of loss from fortuitous events.

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TAM 201149021

The taxpayer in TAM 201149021 was in the business of issuing residual value insurance ("RVI") contracts, and filed a federal income tax return as a non-life insurance company. Under the RVI contracts, the taxpayer received an up-front premium in exchange for the taxpayer's obligation to pay the excess (if any) of the originally projected future (residual) value of a leased asset over the fair market value of the asset at the end of the lease term. The leased assets included passenger vehicles, commercial equipment and commercial real estate that the protected parties leased to third parties. The lengths of the contracts differed according to the lives of the assets; some had a 10- to 25-year term.

The contracts were issued only to policyholders with an economic interest in the asset (presumably the property lessors). Taxpayer's obligation to make a residual value payment matured at the end of the contract term. If taxpayer made a residual value payment, the agreement provided that the taxpayer was either subrogated to the protected party's rights with respect to the covered asset or received title to the covered asset.[12] The taxpayer treated the residual value insurance contracts as insurance contracts for federal income tax purposes, and accordingly took the position it was an insurance company subject to tax under subchapter L.

The IRS disagreed with the taxpayer's position that the contracts were insurance contracts. According to the IRS, the residual value insurance contracts lacked insurance risk, lacked risk distribution, and did not constitute insurance in the commonly accepted sense.

It is possible the IRS felt constrained to reach this conclusion in order to avoid line drawing, or to avoid expanding the definition of insurance to encompass other instruments, such as financial products that are not otherwise governed by existing authorities. In taking the approach that it chose, however, the IRS likely reached the wrong conclusion, and in any event traded one set of unintended consequences for another.

Insurance Risk Requirement and Risk Shifting and Distributing

In the TAM, the IRS noted, citing *Commissioner v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950), "Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk." The IRS then observed that the contracts generally do not protect against damage to the particular asset; instead, they protect against market forces that depress the value of the protected asset at the end of the term. It then concluded that this type of risk is more akin to an investment risk than to an insurance risk. The IRS also concluded that the event that triggers the taxpayer's liability is the termination of the contract. It noted that contract termination is not the type of event that gives rise to a casualty event.

In the RVI contract, the loss was defined as the excess of the predicted residual value of the protected asset as set forth in the contract over the fair market value of the asset at the end of the lease term. The protected party would either be reimbursed for the full amount of its loss or not. If the protected party suffered a loss, it would be reimbursed for that loss, up to the coverage limits of the agreement. As the taxpayer either was subrogated to the protected party's rights with respect to the covered asset or received title to the covered asset, the loss was crystallized as of the termination date, and the protected party may not profit from the insurance proceeds by then selling the covered asset for an amount greater than the amount used to determine the payment received under the RVI contract. The contract itself, through its valuation mechanism, provided reasonable assurance that the loss reflected true market conditions as of the termination date.

The taxpayer also argued that risk distribution was achieved under its policies because the taxpayer insures a multitude of residual value risks of numerous unrelated insureds. The IRS disagreed, observing in the TAM that the taxpayer cannot sufficiently utilize the law of large numbers to distribute its risk among the protected assets to achieve risk distribution in its commonly defined sense. Citing Rev. Rul. 60-275, 1960-2 C.B. 43, the IRS noted that the protection contracts protect against market forces that depress the value of the protected asset. If the market forces are significant, such as a sufficient unemployment rate, the value of most, if not all, protected assets could be depressed. To the extent that the termination dates of the contracts are sufficiently close in time or that the contract applies to pools of assets, the interdependence of the risks supports the examining agent's position that there is no risk distribution. On the other hand, the TAM did not explain how multiple classes of assets, ranging from passenger vehicles to commercial equipment and real estate, and with lives of less than 10 years in some cases to 25 years in others, could be interdependent in the way the floodplain policyholders' risks were interdependent in Rev. Rul. 60-275.

Insurance in the Commonly Accepted Sense

The portion of TAM 201149021 that concludes residual value insurance is not insurance in the commonly accepted sense is six paragraphs long and contains no citations to legal authorities.

It begins by acknowledging a number of factors that should have weighed in favor of concluding the arrangements are insurance in the commonly accepted sense:

- The taxpayer filed NAIC annual statements and was regulated as an insurance company by the various jurisdictions in which it was licensed;
- The contracts were issued in the form of insurance contracts;
- The contracts have provisions that are typically found in insurance policies;
- The protected parties have an ownership interest (i.e., an insurable interest) in the underlying property; and
- The taxpayer paid premium taxes on the amounts received as premiums.

The TAM nevertheless rejected the taxpayer's characterization of the arrangements as insurance in the commonly accepted sense because the losses, if any, resulted from a decline in asset value. According to the TAM, for an arrangement to constitute insurance in the commonly accepted sense, "a casualty event and damage or impairment in some form is required…. While there are insurance policies that may be influenced by a decline in asset value, the insurance company's obligation under these policies still rests on a casualty event and the casualty must cause the decline in value."

The TAM's approach in this regard makes it difficult for taxpayers to anticipate whether the IRS will agree that a particular contract constitutes insurance in the commonly accepted sense and hence may qualify as insurance for federal income tax purposes. In fact, the TAM's analysis raises more questions than it answers:

> Does the TAM's analysis conflate the "insurance risk requirement" and the "insurance in the commonly accepted sense" requirements, applying its independent concept of "casualty" for both purposes?
>
> Stated differently, does the IRS still follow the three-prong analysis of AMERCO and The Harper Group, or in the IRS's view is the "insurance risk" prong really a part of "insurance in the commonly accepted sense"?
>
> Does the IRS believe it matters whether an arrangement satisfies the The Harper Group factors for insurance in the commonly accepted sense—why did it not cite the case?
>
> Is the IRS's notion of insurance in the commonly accepted sense a subjective, "know it when I see it" standard? See, e.g., Jacobellis v. Ohio, 378 U.S. 184 (1964) (applying such a standard to pornography).
>
> If the IRS can reject the insurance characterization of an arrangement that is regulated as insurance and satisfies the standard applied by the Tax Court in The Harper Group, how are taxpayers to anticipate whether, in the view of the IRS, a new or innovative insurance product can ever meet the third prong in AMERCO for insurance characterization?
>
> Although the regulation of an arrangement as insurance is not in itself determinative, wouldn't the IRS have been better off with an approach that demonstrated some degree of deference to the state regulation of an arrangement as insurance, provided no other tax accounting regime applied?

WHETHER OR NOT THE ARRANGEMENTS ARE INSURANCE, THE APPLICABLE METHOD OF ACCOUNTING SHOULD CLEARLY REFLECT INCOME

Absent a specific provision to the contrary, an important responsibility of both taxpayers and the IRS is to apply the Code in a way that achieves a clear reflection of income. This responsibility is implicit in the administration of a tax on income (versus, for example, a tax on gross receipts). It is an element of the tax system's fairness and legitimacy. And, in the long run, it prevents manipulation by taxpayers who benefit by deferring income and accelerating deductions, or vice versa. In fact, the accounting provisions of general application explicitly require a clear reflection of income.[13] In the case of gross income, section 451 requires that an amount of any item of gross income be included in gross income in the taxable year in which received unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period.[14]

Absent a specific provision to the contrary, an important responsibility of both taxpayers and the IRS is to apply the Code in a way that achieves a clear reflection of income.

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In the TAM, a single premium was paid up-front for coverage to be provided over a number of years. Would one expect a clear reflection of income to require such a single payment to be matched with either the period of coverage or the deduction for related claim payments? The TAM did neither, but instead reported all premium income up-front (when received), and deferred all deductions until the end of the contract term (when paid out).

Subchapter L Would Have Recognized Premium Income Ratably as It Was Earned

If the IRS had concluded that the residual value insurance contracts were insurance contracts for federal income tax purposes, the gross premiums written during the taxable year would have been included in gross income (in their entirety) in the first year. The taxpayer would have been permitted a deductible unearned premium reserve under section 832(b)(4), which would have had the effect of recognizing premium income over the term of the contract.[15] Gross income thus would have been neither front-loaded nor back-loaded. Correspondingly, one would ordinarily expect the policyholder's deduction for that premium payment to be recognized ratably over time, and the IRS had previously so concluded. Specifically, in TAM 9830001, the IRS concluded that the premium paid for residual value insurance coverage over a period of years was to be deducted ratably as an insurance premium over the period of the contract. The 1998 TAM did not question whether the residual value insurance qualified as insurance for federal income tax purposes.

Consistently, if the TAM had concluded that the residual value insurance contracts were insurance contracts, deductions would have been allowed at a time and in an amount that arguably are best matched to the relevant periods. Under section 832(b)(5), a deduction would have been permitted for losses paid during the year, and for the change in a reserve for unpaid losses. The reserve for unpaid losses would have been maintained on a discounted basis with regard to losses incurred.[16] Deductions would have been allowed for amounts determined to be "fair and reasonable." The regime for deductions thus would have complemented the regime for recognizing premium income.

Bunching income into the year of receipt, and bunching deductions into the year of payment—sometimes many years later—might make sense in other areas, but not where a pool of income is collected from unrelated parties and used to satisfy fortuitous events. In this sense, subchapter L would have provided a clear reflection of both issuer's income and deductions with regard to the residual value insurance contracts. The TAM, however, ruled out this approach by concluding the contracts were not insurance contracts, and with little explanation imposed the most onerous possible accounting regime: reporting all income at the beginning of the contract term, and all deductions at the end.

Analogously, existing authorities produce a clearer reflection of income with regard to other types of products.

A. If the contracts had been puts, the relevant authorities would have matched gross income to the related items of deduction.

In the case of a put, IRS guidance establishes an accounting regime that clearly reflects income of the issuer, albeit in a manner different from that applied to insurance contracts under subchapter L.

Rev. Rul. 78-182, 1978 1 C.B. 265, sets forth rules for taxing both the writer and the holder of a put or a call. For the writer (issuer) of a put, a wait-and-see approach is prescribed. That is, the premium received for writing the put is not included in income at all, but is carried in a deferred account until the obligation expires, or until the issuer purchases the underlying asset pursuant to exercise of the put, or until the transaction otherwise closes. The ruling further explains the application of section 1234(b) (which applies only to options involving stock, securities or commodities), and sets forth the rule that if the issuer purchases the underlying property pursuant to the holder's exercise of the put, the premium received decreases the issuer's basis in the underlying property.

Because the contracts in the TAM were likely insurance contracts, they were not puts and not governed by Rev. Rul. 78-182. However, the wait-and-see approach of Rev. Rul. 78-281 would have provided a clearer reflection of income under the facts of the TAM than the income-up-front approach that the TAM prescribed. In the case of residual value insurance, the profitability of the transaction is unknown at the time the contract is entered into. In circumstances where the basis is known but the gross income is not yet known, courts apply the "open transaction doctrine" of *Burnet v. Logan*, 283 U.S. 404 (1931), permitting the full recovery of basis before any income is recognized.[17] The TAM presents the inverse. That is, gross income (premiums) is known, but the extent of future deductions (claims) is unknown at the time the contract is en-

tered into. If a goal of tax policy and a measurement of clear reflection of income is the matching of income and deductions, the wait-and-see approach of Rev. Rul. 78-182 would achieve a clear reflection of income under the facts of the TAM. The approach of the TAM takes exactly the opposite approach, taxing gross income in some cases two decades before the related deductions are allowed. A mismatch that spans such a long period of time is not only distortive as a matter of the time value of money, but also eliminates any possibility that net operating losses generated by those deductions could be carried back to the year in which the related premiums were earned.

Treating the residual value insurance contracts as puts would have been more advantageous to the taxpayer in the TAM than the insurance contract accounting that the taxpayer had claimed. That is, taxation as a put would have deferred all premium income until the last year of the contract, rather than recognize it ratably over time. Although it is unimaginable that the IRS was unaware of this alternative characterization, the TAM does not acknowledge it.

B. If the contracts had been notional principal contracts, income would have been more clearly reflected.

Closely related to the economics of a put are the economics of a notional principal contract. Both are financial products under which the rights and obligations of the issuer and holder are determined by reference to the value of underlying assets.

Again, because the arrangements in the TAM were likely insurance contracts, they were not notional principal contracts and not governed by section 1.446-3. Moreover, as a technical matter, the contracts described in the TAM are not notional principal contracts under the notional principal contract (NPC) regulations. Section 1.446-3(c) of the regulations defines a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. A futures contract, a forward contract, and an option are excepted from the definition. Because the contracts in the TAM entailed only a single payment, up-front, by the policyholder, and a single payment by the insurer at the end of the contract term if the value of the underlying assets declined sufficiently, the contracts in the TAM do not fall within the current definition of notional principal contract.[18]

In general, the goal of the NPC regulations is to achieve a clear reflection of income of the parties to a notional principal contract. The regulations do so by distinguishing among periodic payments, nonperiodic payments and termination payments. The parties to a notional principal contract must recognize each year the ratable daily portions of both periodic payments for the taxable year (under section 1.446-3(e)) and nonperiodic payments for the taxable year (under section 1.446-3(f)) to which those portions relate. Termination payments are recognized under section 1.446-3(h) in the year the contract is extinguished, assigned or exchanged. In this way, the regulations avoid the result in the TAM, recognizing as income or deduction in each taxable year the portion of each payment that is related to that year.

In sum, the NPC regulations would almost necessarily provide a clearer reflection of income than the methodology prescribed in the TAM.

C. Could any other method have applied?

Even if the contracts were not insurance contracts, one might reasonably ask whether the IRS could have exercised its general authority under section 446 to achieve a clearer reflection of income under the facts of the TAM.

Section 446 provides the general rule for taxpayers' methods of accounting. Under this provision, taxable income generally is computed under the method of accounting on the basis of which a taxpayer regularly computes income in keeping its books. If no method of accounting has been regularly used, or if the method used does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income. Section 446 explicitly permits the use of the cash method or accrual method of accounting, or any other method or combination of methods permitted under the Code and regulations, subject to the overall requirement that the method clearly reflect income.

In sum, the NPC regulations would almost necessarily provide a clearer reflection of income than the methodology prescribed in the TAM.

Thus, even if the IRS was correct that the contracts at issue in the TAM were not insurance contracts for federal income tax

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purposes, and even if they were not puts, the IRS may have had authority to permit the use of a method that reflected income more clearly than the method it imposed in the TAM. In fact, the IRS exercised its authority to prevent up-front recognition of insurance income in Rev. Proc. 97-38, 97-2 C.B. 479, where it instead permitted taxpayers to use the Service Warranty Income Method (SWIM) to recognize such income over time as related deductions were recognized. It is possible that IRS did not do so in the TAM because it felt such a method would first need to be authorized by published guidance such as a regulation, revenue ruling or notice. What is clear is that the method set forth in the TAM matches the premium income of the taxpayer with neither the period it is earned nor the deductible expenses that relate to it. Under the facts of the TAM, the mismatch with regard to some contracts may be as great as 25 years.

HOW MIGHT THE ANALYSIS IN THE TAM APPLY TO OTHER FORMS OF INSURANCE OR REINSURANCE?

It is likely that the IRS opted not to treat the residual value insurance contracts as insurance to avoid sweeping into subchapter L a variety of financial products not heretofore acknowledged as insurance by the IRS.[19] Despite the narrow view of insurance evidenced in the TAM, the IRS is unlikely to challenge the insurance characterization of arrangements that are already widely recognized as insurance, such as title insurance, surety insurance, life insurance, ocean marine fleet insurance, marine "total loss only" insurance, underground storage tank liability insurance, crop insurance and financial guaranty insurance. In fact, the TAM goes to great lengths to distinguish several of these types of insurance on the basis of a casualty event that triggers liability.

Other types of insurance for which the IRS has previously expressed skepticism may be no closer to resolution as a result of the TAM's analysis. For example, the IRS has previously expressed skepticism on the insurance characterization of finite risk transactions and loss portfolio transfers.

In Notice 2005-49, 2005-2 C.B. 14, the IRS asked for comments on four insurance-related legal issues, including finite risk transactions. At the time, finite risk transactions were in the news due to uncertainty about the standards for determining when such transactions should be accounted for insurance and when such transactions should be accounted for as financing arrangements. Although no published guidance resulted from this request for comments, useful comments were received, some of which urged deference to the determination of a state insurance regulator that sufficient risk was transferred to qualify an arrangement as insurance.[20] The TAM's subjective approach to what constitutes "insurance in the commonly accepted sense," its failure to acknowledge the standards for this determination in *The Harper Group*, and its reluctance to defer to state insurance regulation, leave taxpayers with little guidance on how the IRS would propose to draw the line between transactions that qualify as insurance and those that do not.

Likewise, the IRS's view of a pure loss portfolio transfer is no closer to resolution as a result of the TAM's subjective analysis of what constitutes insurance in the commonly accepted sense. In Rev. Rul. 89-96, 1989-2 C.B. 114, the IRS held that a purported insurance contract based on a catastrophe that already had occurred did not qualify as an insurance contract for federal income tax purposes. Important to the ruling's analysis was the fact that under the contract it was reasonable to expect that the amount of net premium received, plus the amount of tax savings, plus the investment income earned on these amounts, would probably exceed the maximum liability under the contract. Consistently, in Rev. Rul. 2007-47, 2007-2 C.B. 127, the IRS concluded that a purported insurance contract based on an environmental remediation liability that was sure to be incurred (albeit at an unknown time and in an unknown amount) was not an insurance contract. Again, important to the ruling's analysis was a policy limit that would be reached or not reached based on the timing of any claim payment and investment performance of the insurer. Neither ruling considers what result would obtain if the contract entailed sufficient risk shifting to be treated as insurance for regulatory and accounting purposes, and the policy limit were so high that the likelihood of reaching it was remote. The TAM's subjective view of "insurance in the commonly accepted sense" leaves unanswered what standard the IRS would apply in such a case.

CONCLUSION

Whether or not it is correct, the conclusion in TAM 201149021 represents a predictable move by a tax administrator concerned with line drawing and unintended expansion of subchapter L accounting to new and different areas. In this sense, the TAM is not a surprise.

It is unfortunate, however, that the IRS cited no legal authorities to support its assertion that an arrangement that apparently satisfies the requirements of *The Harper Group*

nevertheless does not qualify as insurance in the commonly accepted sense. Taxpayers are left with little guidance as to how the IRS might apply the prong in other cases.

It is also unfortunate that, in its efforts to exclude less-traditional insurance products from subchapter L, the IRS denied the taxpayer in this case an accounting regime that would have provided a clear reflection of income. In fact, the TAM seems to go out of its way not only to keep the contracts out of subchapter L, but also to impose an onerous accounting regime that demonstrably front-loads income to a large degree. It was unnecessary for the TAM to do so.

Going forward, practitioners need to consider whether the TAM's approach poses potential for whipsaw. For example, are policyholders and companies whipsawed where a multi-year premium payment is fully included in income under the logic of TAM 201149021, but the corresponding deduction by the policyholder is deferred under the logic of TAM 9830001? Is the government whipsawed when an insurance company that needs taxable income (such as to prevent NOLs or other tax attributes from expiring) enters into this line of business with regard to long-life assets? Most importantly, does the TAM represent a different standard for the clear reflection of income of a taxpayer that is regulated as an insurance company? The merits of the TAM will be debated for a long time.

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END NOTES

[1] Although *Helvering v. LeGierse*, 312 U.S. 531 (1941), is the landmark case most often cited as the starting point for analyzing what is insurance for federal income tax purposes, the three-prong test is often associated with *AMERCO v. Commissioner*, 96 T.C. 18 (1991), aff'd 979 F.2d 162 (9th Cir., 1992).

[2] *See, e.g.*, Rev. Rul. 60-275, 1960-2 C.B. 43 (the "flood plain" ruling); Rev. Rul. 77-316, 1977-2 C.B. 53, obsolete by Rev. Rul. 2001-1 C.B. 1348 (first articulating the "economic family" theory).

[3] Rev. Rul. 2001-31, 2001-1 C.B. 1348 (obsoleting several revenue rulings and explaining that IRS would no longer raise the "economic family theory" in addressing whether an arrangement constitutes insurance).

[4] *See also* section 1.801-3(a) (promulgated in 1960 when the relevant test was "primary and predominant" rather than "more than 50 percent," the regulation makes clear that it is the character of the business actually done during the taxable year that determines whether a company is taxable as an insurance company).

[5] *See, e.g., Estate of Walter C. Burr v. Commissioner*, 156 Fed.2d 871 (2d Cir., 1946), *certiorari denied* 329 U.S. 785, and *Estate of Eustace R. Conway v. Glenn*, 193 Fed.2d 965 (6th Cir. 1952), both applying *LeGierse* for their analysis.

[6] The rationale of Rev. Rul. 60-275 was specifically rejected in *U.S. v. Weber Paper Company*, 320 F.2d 199 (8th Cir. 1963) which held, on similar facts, that once the premium deposits had been made taxpayer had relinquished its dominion and control over the funds and therefore the amounts were deductible in the year of payment. In Rev. Rul. 64-72, 1964-1 C.B. 85, the IRS restated its position in Rev. Rul. 60-275 and announced it would not follow the decision in *Weber Paper*.

[7] *See, e.g.*, FSA 200105014 (Oct. 26, 2000); FSA 200043012 (Oct. 27, 2000); FSA 200125005 (June 22, 2001); FSA 200125009 (June 22, 2001); FSA 200029010 (July 21, 2000).

[8] Rev. Rul. 2001-31, 2001-1 C.B. 1348.

[9] In addition, by analogy, *see* Theodore R. Groom letter to the IRS, dated May 11, 2011, recommending that published guidance confirm that, under Rev. Rul. 9293, 1992-2-C.B. 144, distinguishing the single-insured analysis of Rev. Rul. 2005-40 from a company's insurance of certain employee benefits under a medical stop-loss arrangement. Tax Analysts Doc. 2011-11073.

[10] 1990 LGM TL-85 (Jan. 24, 1990).

[11] *See, e.g.,* Gelfond, Frederic J., *Fortuity, or not Fortuity? ... That is the Question,* TAXING TIMES (September 2008).

[12] As a practical matter, it is not clear how subrogation would work when there is only a decline in market value.

[13] See, *e.g.*, section 446(b) (If the method of accounting regularly used by the taxpayer does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income.); 1.446-1(a)(2) ("A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.")

[14] In the case of personal service income, this rule is generally applied to mean up-front inclusion in income even for a contract that extends beyond the end of the taxable year. *See Schlude v. Commissioner*, 372 U.S. 128 (1963). *But see* Rev. Proc. 97-38, 97-2 C.B. 479 (IRS commissioner's exercise of discretion to permit the use of the service warranty income method, rather than the up-front income inclusion required under *Schlude v. Commissioner,* to account for amounts received as premiums for service warranties on durable goods such as automobiles).

[15] Under section 832(b)(4)(A) and (B), the unearned premium reserve would have been subject to a 20 percent haircut, which is a proxy for capitalizing acquisition costs.

[16] When a loss is treated as "incurred" for this purpose is a different issue and beyond the scope of this article.

[17] The open transaction doctrine is generally applied sparingly. *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir., 1975); *McShain v. Commissioner*, 71 T.C. 998, 1004 (1979).

[18] Regulations proposed in September 2011 would modify this definition. At least one insurance trade association commented on the proposed modification, expressing concern that if the proposed regulations were finalized in their current form, some traditional insurance contracts could fall within their scope. Walter Welsh and Peter Bautz letter on behalf of the American Council of Life Insurers, dated Dec. 14, 2011 (Tax Analysts Doc. 2011-26810).

[19] Notice 2004-52, 2004-2 C.B. 168, analogized credit default swaps to insurance contracts. Regulations proposed in September 2011 would explicitly reject insurance characterization and would add credit default swaps to the list of swaps categorized as notional principal contracts governed by the rules of section 1.446-3. 76 Fed. Reg. 57684 (Sept. 16, 2011).

[20] *See, e.g.,* Brenda Viehe Naess letter on behalf of the Reinsurance Association of America (RAA) and the National Association of Mutual Insurance Companies (NAMIC), dated Oct. 3, 2005.

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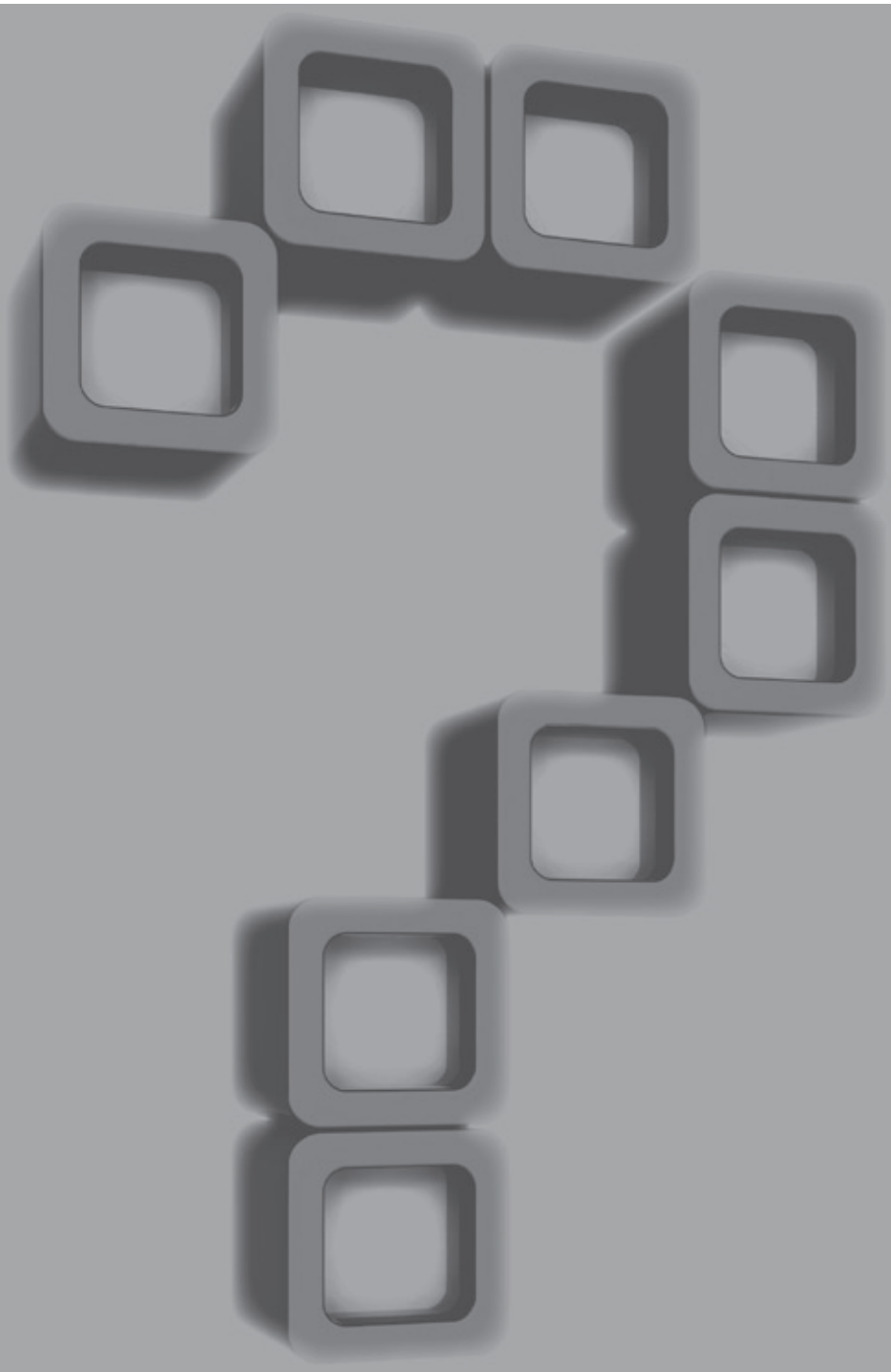

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IRS RULES ON NEW BOLI ARRANGEMENT

By John T. Adney and Bryan W. Keene

At year-end 2011 the Internal Revenue Service (IRS) released to the public a somewhat groundbreaking private letter ruling it had issued the prior September on a new kind of arrangement involving bank-owned life insurance (BOLI). Under the facts of PLR 201152014 (the Ruling),[1] a partnership of banks was formed to pool and manage the banks' BOLI contracts and, in the process, exchange some or all of them for new contracts. Technically, the transferee of the contracts was a limited liability company (LLC) that planned to elect to be treated as a partnership for federal income tax purposes. The Ruling addresses both the eligibility of the LLC to be taxed in that manner as well as a number of the tax consequences flowing from the LLC's tax treatment as a partnership.

According to the Ruling, initially the LLC would have three members—a BOLI broker denominated the Managing Member, a national bank called Bank A in the Ruling, and a Federal Reserve Board-regulated financial holding company referred to as Bank B—although it was anticipated that other banks would join as members over time. Both Bank A and Bank B owned BOLI policies (Policies), some covering current employees and some former employees, and some of the Polices were fixed, general account contracts while others were variable contracts based on separate accounts. Significantly for the Ruling's various holdings, after contributing their Policies, Bank A would hold a greater-than-50 percent interest in the LLC, whereas Bank B would hold only a minority interest in it. (The Ruling noted that when other banks joined the LLC, Bank A's interest likely would dip below 50 percent, too.) The Ruling recited that only Policies in force for five years, and under which the insureds had been given notice of the coverage and consented to it, would be accepted into the LLC, and that banks must represent that the LLC's holding of the Policies would not enable them to have BOLI holdings beyond the limits prescribed by bank regulators.[2]

The IRS was told (according to the Ruling) that the banks who became LLC members would benefit in a number of ways. Specifically, they would receive death benefits when paid under the Policies (plus any other profits and less any losses) in proportion to their interests in the LLC, and in the meantime they would enjoy having "a more effective, centralized way to manage Policies and, where appropriate, to negotiate the terms of new Policies (i.e., via exchange) or renegotiate the terms of existing BOLI holdings." In other words, the members expect the LLC to exchange most or all of the Policies for new ones, although, technically, this decision would be left to the Managing Member. What the members could not do, however, is have the LLC redeem their interests. Rather, any bank wishing to withdraw would need to sell its interest to another bank, but it would also need to obtain the Managing Member's consent to this, which the IRS was told would be given only in "rare and extraordinary circumstances."

The Ruling addressed three aspects of the tax treatment of the arrangement: (1) the LLC's taxation as a partnership as opposed to an investment company, (2) the deductibility of interest expenses by the LLC and its members, and (3) the excludability of death benefits under the Policies, which began life as employer-owned life insurance contracts.

PARTNERSHIP TAXATION—SECTIONS 721 AND 351[3]

First, the Ruling addressed a potential barrier to the treatment of the LLC as a partnership for tax purposes, holding that the banks' transfer of Policies to the LLC would not be treated as a transfer to an "investment company" within the meaning of section 351 if the LLC were incorporated. The significance of this holding, which was the sole legal element of the Ruling that was truly groundbreaking, requires some explanation, starting with the reason why it was asked of the IRS.

In general, the character of income earned by a partnership is passed through to the partners. Thus, life insurance death benefits paid to a partnership, assuming that the underlying life insurance contracts meet the requirements of the federal tax definition (section 7702), normally would be income-tax-

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free in the hands of the partners because they would be excludable from the partnership's gross income pursuant to section 101(a)(1). However, under the "transfer-for-value rule" of section 101(a)(2), if a life insurance contract is transferred "for a valuable consideration," the income tax exclusion is limited to the consideration and any subsequent premiums that the transferee paid for the contract. Since, under the facts of the Ruling, banks would transfer their Policies to the LLC in return for interests therein, then, absent an exception, the transfer-for-value rule would apply and the death benefits would lose their tax-free treatment. One exception to this rule is for "carryover basis," *i.e.,* the rule does not apply if the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis.[4] The good news for the LLC in this case is that such a carryover basis normally applies under section 723 when property is contributed to a partnership, so that, as long as the transfer of the Policies to the LLC is treated as a contribution of property to an entity recognized as a partnership for tax purposes, the transfer-for-value rule would not apply.[5]

This led to the LLC's concern with partnership treatment and, in turn, with the question about "investment company" characterization. As a general matter, under section 721(a), no gain or loss is triggered when a person acquires a partnership interest by transferring property to the partnership. Section 721(b) overrides this rule, however, if the partnership would be treated as an investment company within the meaning of section 351 if it were incorporated. Rather, the investment company rules of sections 721(b) and 351 can operate to tax property when contributed to a partnership, and, if so, the transferor's basis in the property would not carry over to the partnership, rendering the carryover basis exception to the transfer-for-value rule unavailable.

The Ruling's holding, confirming that sections 721(b) and 351 would not preclude the normal partnership tax rules from applying to the banks' transfer of Policies to the LLC, is somewhat groundbreaking. The Ruling reasoned that, because the LLC's assets are to consist solely of the Policies and some cash, its assets would not be viewed as comprised of "stock and securities," thereby precluding investment company treatment.[6] The IRS's view that the Policies are not stock and securities within the meaning of section 351(e) is noteworthy, in that the provision broadly defines stock and securities to include money, equity interests in a corporation, evidences of indebtedness, and any equity interest or other arrangement that is readily convertible into cash.[7] The Policies have attributes that make them similar to such investments, *e.g.,* variable Policies are treated as securities under federal securities laws, and both general and separate account Policies can be converted to cash through surrender or withdrawal. Unfortunately, even though the Ruling broke legal ground with its holding, its reasoning on the point was terse at best.

DEDUCTIBILITY OF INTEREST EXPENSE—SECTION 264(f)

Section 264(f)(1) disallows some or all of the deduction for interest expenses by a business that owns or benefits from a life insurance contract with unborrowed cash values, *e.g.,* the typical BOLI contract, even though such expenses are unrelated to the purchase or maintenance of the contract.[8] Pursuant to an exception provided in section 264(f)(4)(A), however, this disallowance does not apply in the case of a contract covering a single insured who, at the time first covered under the contract, was a 20 percent owner of the policyholder or was an officer, director or employee of the policyholder's trade or business (for simplicity, an "employee"). In Rev. Rul. 2011-9,[9] the IRS held that this exception is not available with respect to a new contract received in exchange for an existing contract if, at the time of the exchange, the insured is no longer an employee but is merely a former or "inactive" employee of the policyholder.[10] Hence, a bank that exchanges a BOLI contract covering the life of a former employee at the time of the exchange will lose a portion of its interest deductions unrelated to the contract.

In its ruling request, the LLC asked the IRS to construe the application of the section 264(f) rules to its current two members, Bank A (the majority shareholder) and Bank B, as well as to itself. In response, the Ruling held that a portion of Bank A's interest deductions unrelated to the Policies or to Bank A's interest in the LLC may be disallowed under section 264(f)(1) because of the unborrowed cash values of the Policies held by the LLC, whereas Bank B's interest deductions would not be disallowed under section 264(f)(1) by virtue of the LLC's holding of the Policies. The Ruling also concluded that, to the extent the LLC directly incurs interest expenses unrelated to the Policies, section 264(f)(1) will preclude the bank-members from claiming deductions for their proportionate share of those expenses. In this regard, the Ruling observed that while section 264(f)(5)(B) states that in the case of a partnership section 264(f)(1) applies at the partnership level (rather than the partner level), the denial of interest deductions resulting

from the partnership owning life insurance contracts with unborrowed cash values flows through to the bank-partners pursuant to the flow-through nature of the partnership income tax regime. Practically speaking, however, this disallowance likely would not matter, as the IRS was told that any interest expenses unrelated to the Policies that the LLC may incur would be immaterial.

The basis for the distinction made in the Ruling between the treatment of Bank A and that of Bank B arises from section 264(f)(8), which imposes an aggregation rule under which Bank A and the LLC are treated as a single taxpayer for purposes of section 264(f)(1) because Bank A's ownership interest in the LLC exceeds 50 percent. Thus, for purposes of section 264(f)(1), the ownership of the Policies is attributed to Bank A despite its transfer of their legal ownership to the LLC. In contrast, because Bank B possesses only a minority interest in the LLC, the aggregation rule would not apply to treat Bank B and the LLC as a single taxpayer under section 264(f)(1), thereby allowing Bank B to escape the disallowance rule. By implication, Bank B's favorable treatment would apply to Bank A if and when a sufficient number of additional banks joined the LLC to dilute Bank A's interest below 50 percent.

The Ruling's section 264(f) holdings mean that the bank-members of the LLC, assuming that they confine themselves to minority interests therein, can avoid the disallowance of interest deductions otherwise imposed under Rev. Rul. 2011-9 with respect to new coverage on their former employees—by transferring the Policies to the LLC and having the LLC conduct the exchanges. This follows from the Ruling's treatment of Bank B, which is not viewed as owning any interest in the Policies held by the LLC, and from section 264(f)(5)(B), which states section 264(f)(1) applies at the partnership level. Thus, whether the Policies cover the lives of current or former employees of Bank B at the time of the exchange is immaterial for purposes of section 264(f)(1).

Of course, the ability of the LLC (or of Bank A or Bank B, for that matter) to engage in an exchange that results in the issuance of a Policy covering the life of a former employee presupposes that the Policy received in the exchange will be treated as a life insurance contract under sections 7702 and 1035, which is necessary for the exchange to be tax-free and for the new Policy to provide tax-deferred inside buildup and a tax-free death benefit. Section 7702 defines the term "life insurance contract" for all purposes of the Code as a contract that is a life insurance contract under "the applicable law" and that meets certain other requirements; and for contracts issued in the United States, the reference to "applicable law" means state law, which incorporates such laws' requirements with respect to "insurable interest."[11]

Based on concepts inherited from English law (the Life Assurance Act of 1774), all states require the initial owner of a life insurance contract to possess an insurable interest in the life of the insured under the contract at the time of its issuance. Many states also have statutes expressly recognizing the insurable interest of an employer in the lives of its employees, *e.g.,* to the extent that they are covered under an employee benefit plan. Because insurable interest typically must be established only at the time a contract is issued, the fact that an insured's employment is subsequently terminated generally does not affect the continued validity of the contract under state law in the hands of the employer. In this connection, the transfer of the Policies to the LLC and the subsequent exchanges by the LLC raise two questions. First, does the transfer of the Policies require re-establishing insurable interest at the time of the transfer? If so, then presumably it would need to be shown that the LLC (not the employer) possesses insurable interest in the insureds under the Policies at the time of the transfer. Second, would insurable interest need to be established at the time of an exchange? If so, then again, the LLC's insurable interest in the new contract acquired in the exchange would need to be demonstrated.

In seeking the Ruling, the LLC represented to the IRS that the Policies, at issuance and upon transfer to the LLC, would meet all applicable state insurable interest laws, and that the LLC's exchanges of the Policies would comply with those laws. Since the insureds under the Policies would not be employees of the LLC, and a fair number of them would likely be merely former employees of the LLC's members, it would seem vital to obtain clarity on these points.[12] The consequences of failing to comply with state insurable interest laws would be the loss of the favorable income tax treatment of the Policies and of the exchanges, not to mention that the Policies could be deemed to be void or else the death benefits could be re-directed to the insureds' own heirs.[13]

EXCLUDABILITY OF DEATH BENEFITS—SECTION 101(j)

To address abuses perceived in the corporate-owned life insurance market, in 2006 Congress enacted section 101(j) to

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impose special requirements on "employer-owned life insurance contracts" (EOLI). Under this provision, in order for the employer-policyholder to obtain a tax-free death benefit when an insured employee dies, the employer must satisfy certain notice and consent requirements prior to the time the contract is issued.[14] An exchange of an existing EOLI contract will retrigger these notice and consent requirements unless (1) the exchange occurs within a year of the issue date of the contract being exchanged, or (2) the exchange does not result in a material change in the death benefit or other material change in the contract.[15] In addition, the insured at issuance of an EOLI contract must be a director, a highly compensated employee, or a highly compensated individual with respect to the policyholder.[16] If these requirements are not met, the contract's death benefit is taxable to the extent that it exceeds the policyholder's investment therein.[17] For purposes of these rules, an EOLI contract is defined as one (a) owned by a trade or business, (b) directly or indirectly benefitting that trade or business (or a related party), and (c) covering the life of an insured who is an employee with respect to the trade or business of the "applicable policyholder" on the date the contract is issued.[18]

The Ruling reached two divergent conclusions regarding the section 101(j) treatment of the Policies in the hands of the LLC, including those it receives in exchange for Policies contributed to it. First, according to the Ruling, each Policy would constitute an EOLI contract as defined in section 101(j)(3)(A) if it covers the life of an insured who, on the date the Policy is issued, is either an employee of the LLC or an employee of Bank A. As regards Bank A, this conclusion stems from aggregation rules under section 101(j) that identify the "applicable policyholder" with respect to an EOLI contract. Like the section 264(f) aggregation rule, the section 101(j) rule treats Bank A and the LLC as the same taxpayer by virtue of Bank A's majority interest in the LLC. (Although the Ruling referred to insureds who are LLC employees, it said nothing about the LLC actually having employees; if the only Policies held by the LLC are those transferred to it by banks, it would seem that an insured would be an LLC employee only by happenstance, assuming the LLC had any employees at all.)

Second, in contrast, the IRS said that a former Bank B Policy transferred to the LLC would not constitute an EOLI contract if it covers the life of an insured who, on the date the Policy is issued, is an employee of Bank B but not of the LLC. In other words, the aggregation rule would not apply to Bank B, since it holds less than a 50 percent interest in the LLC. Rather, after Bank B transfers its Policies to the LLC, the LLC would be the only "applicable policyholder" with respect to those Policies, and because those Policies would not cover the lives of any employees of the LLC, they would not be EOLI contracts. This means, in turn, that the section 101(j) rules—including the notice and consent requirements and the limits on the insured population—would no longer apply to the former Bank B Policies or to any that replaced them through an exchange.[19]

Importantly, albeit by implication, the favorable Bank B treatment ultimately would apply to Bank A, once a sufficient number of additional banks joined the LLC to dilute Bank A's interest below 50 percent (just as in the case of section 264(f)). Thus, Bank A would be in the same posture as Bank B (and presumably all the other bank-members), so that none of the Policies that the LLC holds would be EOLI contracts. This is significant for the success of the exchanges proposed under the arrangement, in that the notice and consent requirements of section 101(j) would not apply upon any such exchange. That said, it is worth noting that many states impose notice and consent requirements on employers who purchase life insurance coverage on their employees. In such states, the employer must provide notice to the employees before purchasing the coverage and/or obtain the employees' consent to the coverage. Like the insurable interest requirements discussed above, states that impose notice and consent requirements may view them as re-applying upon the exchange of an existing contract for a new one. In this connection, in seeking the Ruling the LLC told the IRS that it would accept transfers of Policies only if the insureds thereunder were provided notice of the coverage and had consented to it. The Ruling, however, did not indicate that the LLC would provide new notice and obtain new consents upon the exchange of Policies for new ones, and the Ruling's conclusions on the application of section 101(j) suggest that the LLC has no plan to do so.

The Ruling's conclusions also would seem to provide a taxpayer-friendly outcome on the effective date of the section 101(j) rules. Section 101(j) generally applies to contracts issued after Aug. 17, 2006, subject to certain transition rules. Under those transition rules, section 101(j) does not apply to:

> a contract issued after [Aug. 17, 2006] pursuant to an exchange described in section 1035 … for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract ….[20]

The apparent generosity of this "grandfather" rule for EOLI contracts received in a section 1035 exchange is deceptive, at

least in the IRS's eyes. The IRS has narrowly construed the rule by stating in published guidance that any material change to a contract involved in such an exchange—other than changing the issuer—will result in a loss of the grandfather.[21]

In light of this, yet another significant consequence of the Ruling's holding that the Policies are not EOLI contracts in the LLC's hands is that its members would no longer need to worry about material changes to the Policies triggering a loss of any grandfather. In this sense, the structure would appear to liberalize the transition rules that apply to section 101(j), at least in circumstances where the contracts would be viewed as undergoing material changes when exchanged.

CONCLUDING THOUGHTS

The Ruling reached favorable determinations on the treatment of the BOLI arrangement under sections 721 and 351 (partnership taxation), section 264(f) (deductibility of interest expenses) and section 101(j) (EOLI contracts). Those determinations would appear to facilitate the ability of the LLC's bank-members to have their existing Policies exchanged for new ones in circumstances where sections 264(f) and 101(j) would otherwise impose adverse federal income tax consequences or at least requirements that would be difficult to meet.[22] For example, from a tax standpoint, the LLC would be able to exchange Policies that cover the lives of its members' former employees without the need to provide notice to, or seek consent from, those individuals. While this would eliminate the practical barrier of locating and convincing former employees to consent to coverage that their former employers wish to maintain (indirectly) on their lives, similar notice and consent requirements may apply under state law when the Policies covering them are exchanged, assuming that state insurable interest laws allow such exchanges to occur.

While those of us who write for *Taxing Times* often take a purely tax-centric view of the universe, we are forced to acknowledge that there are in fact some other laws of importance, however fleeting they may seem to us. The Ruling, of course, being an IRS product, did not endeavor to address the application of these other laws to the BOLI arrangement. Among the issues not addressed in the Ruling, but that would appear critical to the arrangement's viability, would be not only the application of the state law requirements mentioned above (insurable interest laws and notice and consent laws) but also the manner in which the non-tax regulatory requirements governing banks would apply to the arrangement. Banking institutions are subject to regulation by a variety of federal and state agencies, which monitor the activities and investments of banks—including BOLI purchases—to ensure that they are consistent with safe and sound banking practices. Likewise, the accounting for banks' interests in the LLC would be of concern to the SEC as well as the banking regulators. Thus, while the Ruling broke some important ground in the tax law, a bank planning to participate in an arrangement like the one described in the Ruling presumably would need to obtain comfort on these additional issues.[23]

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END NOTES

1 Dated Sept. 22, 2011, and released to the public on Dec. 30, 2011. A private letter ruling cannot be cited as precedent, and only the taxpayer who received it can rely on it. See section 6110(k)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

2 *See, e.g.,* Interagency Statement on the Purchase and Risk Management of Life Insurance, OCC Bull. 2004-56, at 5 (Dec. 7, 2004) (stating that "it is generally not prudent for an institution to hold BOLI with an aggregate [cash surrender value] that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines").

3 Unless otherwise indicated, the term "section" refers to a section of the Code.

4 Section 101(a)(2)(A).

5 Rev. Rul. 72, 1953-1 C.B. 23 (concluding that the carryover basis exception to the predecessor provision of section 101(a)(2) applied to the contribution of a life insurance contract to a partnership because the partnership tax rules provide for a carryover basis with respect to property contributed to a partnership).

6 Technically, the Ruling reasoned that more than 80 percent of the LLC's assets would not be comprised of stock and securities. Under section 351(e) and Treas. Reg. section 1.351-1(c)(1)(ii), if more than 80 percent of a company's assets are comprised of stock and securities, and certain other requirements are met, the company is treated as an investment company. The IRS's conclusion that the Policies are not stock and securities obviated the need for it to consider the other factors that apply in determining whether a company is an investment company.

7 Section 351(e)(1)(B)(i), (ii) and (iv).

8 These restrictions apply only to contracts issued after June 8, 1997, but they also can apply to contracts issued before that date if the contracts are "materially changed." Pub. L. No. 105 34 § 1084(d)[(f)] (1997).

9 2011-12 I.R.B. 554. For a discussion of Rev. Rul. 2011-9, see John T. Adney and Bryan W. Keene, "IRS Ruling Confirms Exchange of COLI on Former Employees Triggers Loss of Interest Deductions," *Taxing Times*, September 2011, Vol. 7, Issue 3.

10 *See also* PLR 200627021 (July 7, 2006) (reaching the same conclusion as Rev. Rul. 2011-9).

11 *See, e.g.,* H.R. Rep. No. 98-861, at 1075 (1984) (Conf. Rep.) (referring to "state or foreign law" in describing the "applicable law" requirement of section 7702); Dow Chem. Co. v. United States, 250 F. Supp. 2d 748, 796 (E.D. Mich. 2003), *rev'd on other grounds,* 435 F.3d 594 (6th Cir. 2006), *cert. denied* 127 S.Ct. 1251 (2007) (recognizing that for purposes of section 7702 "applicable law" means state law, and that such law subsumes the insurable interest requirement).

12 In March 2011, the NAIC's Director of Regulatory Services sent a memorandum to the NAIC's Life Insurance and Annuities (A) Committee recommending that state insurable interest laws be amended to permit exchanges of corporate-owned life insurance contracts that insure the lives of former employees and that state notice and consent requirements be amended to eliminate any requirement to provide new notices to insured employees or obtain new consents from them in connection with such exchanges.

The A Committee ultimately tabled the recommendation. Thus, in the authors' understanding, only the laws of Delaware, Georgia and Utah expressly provide an employer with an insurable interest in a former employee across an exchange. If exchanges were to occur that were subject to the laws of those states, it would seem necessary to determine that an entity like the LLC in the Ruling could derive its insurable interest in the insureds from the interests of the employers.

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END NOTES CONT.

[13] The insured employees, or their estates or legal heirs, may bring lawsuits in state courts (or federal courts under diversity of citizenship) if the Policies were acquired in violation of state law. *See, e.g.,* Mayo v. Hartford Life Ins. Co., 354 F.3d 400 (5th Cir. 2004).

[14] Section 101(j)(4). For an in-depth discussion of section 101(j), *see* John T. Adney, Kirk Van Brunt and Bryan W. Keene, "COLI in Congress: New Tax Rules Address Concerns and the Product's Future," Journal of Financial Service Professionals, March 2007, Vol. 61, No. 2 (Society of Financial Service Professionals 2007).

[15] Q&A-16 and Q&A-9, respectively, of Notice 2009-48, 2009-24 I.R.B. 1085. A "material change" for this purpose does not include a change from general account to separate account or vice versa, or a change in the identity of the issuing life insurance company. *See* Q&A-15 of Notice 2009-48. For a discussion of Notice 2009-48, see John T. Adney, Bryan W. Keene and Joel W. Mann, "Guidance Released on COLI Best Practices Rules," *Taxing Times*, September 2009, Vol. 5, Issue 3. A broader discussion of "material change" concepts appears in the article published as a supplement to the current issue of *Taxing Times. See* John T. Adney and Craig R. Springfield, "They Go Bump in the Night: Life Insurance Policies and the Law of Material Change."

[16] Section 101(j)(2)(A)(ii). Other exceptions to the limitations on the insured population are available, but generally do not apply to the typical broad-based BOLI plan.

[17] Section 101(j)(1).

[18] Section 101(j)(3)(A).

[19] This also would relieve both Bank B and the LLC from the reporting requirements that section 6039I imposes with respect to EOLI contracts.

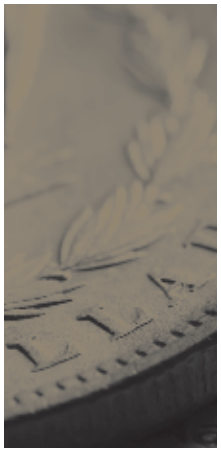
[20] Pub. L. No. 109-280 § 863(d).

[21] *See* Q&A-15 of Notice 2009-48, 2009-24 I.R.B. 1085.

[22] As summarized by the law firm of Locke Lord Bissell & Liddell LLP, which represented the parties in obtaining the Ruling, "[t]he basic lesson to be drawn from PLR 201152014 is that by utilizing a LLC, a bank may be able to manage its BOLI holdings in ways that it could not do on its own as a practical matter, given the constraints of sections 264(f) and 101(j)." Kirk Van Brunt, *Important IRS Private Letter Ruling on Bank-Owned Life Insurance Policies,* Locke Lord Quickstudy, Corporate Insurance Practice (Jan. 11, 2012) (available at http://www.lockelord.com/qs_2011corpins_irsletter/).

[23] *See* Matthew Schoen, *New IRS PLR Portends Trickle of 1035 Exchanges, Not a Flood,* Insurance Broadcasting (Jan. 1, 2012) (available at *http://www.insurancebroadcasting.com/news/IRS-2720923-1.html*) (subscription required) (identifying the resolution of banking law and state insurable interest law as two items on the "long list of steps to check off before proceeding" with the transaction).

FOREIGN INSURANCE SUBSIDIARIES' RESERVE AMOUNTS MAY BE USED TO DETERMINE FOREIGN PERSONAL HOLDING COMPANY INCOME



By Kevin M. Owens

In PLR 201151008, the Internal Revenue Service (the "Service") has ruled that the loss reserves (claim reserves) and underwriting reserves that are held by foreign subsidiaries for life insurance and annuity contracts and are required to be filed with the life insurance regulators of the relevant foreign country are an appropriate means of measuring income under section 954(i)(4). Accordingly, these reserve amounts may be used in determining the company's foreign personal holding company income under section 954. The private letter ruling provides some technical guidance on what foreign financial statement reserves the Service may consider to be appropriate for determining subpart F income and follows prior rulings that the Service has issued.[1] More importantly, the private letter ruling highlights an area on which insurance companies may not have focused. In recent years, U.S. insurance companies and other U.S. investors have invested in foreign insurance markets by acquiring interests in foreign insurance companies. Frequently, the foreign insurance companies qualify as controlled foreign corporations (CFCs). The U.S. shareholders of these CFCs must annually determine the subpart F income and the earnings and profits of the CFC.

BACKGROUND

In general, section 951(a) of the Internal Revenue Code (the "Code") requires that a U.S. shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income for each year. In the case of a CFC's insurance business, subpart F income will generally include section 953 "insurance income" and section 954 foreign base company income, specifically, "foreign personal holding company income" as defined in section 954(c)(1). Section 953(a) broadly defines subpart F insurance as any income which is attributable to issuing (or reinsuring) of an insurance or annuity contract, and which would be taxed under subchapter L if the income were the income of a domestic insurance company. However, subpart F insurance income does not include "exempt insurance income" defined in section 953(e). Generally, the rules of subchapter L are used to determine section 953(a) insurance income. One exception is that reserves for any insurance or annuity contract are determined in the same manner as under section 954(i).

Generally, section 954 foreign personal holding company income includes the investment income of an insurance business, *e.g.,* dividends, interest, royalties, rents, gains and losses from the sale or exchange or property, net gains from commodity transactions and net foreign currency gains. However, foreign personal holding company income does not include "qualified insurance income" of a "qualifying insurance company." "Qualified insurance income" is income from an unrelated person that is derived from investments by a "qualifying insurance company" or a "qualifying insurance company branch" of its reserves or 80 percent of unearned premiums allocable to exempt contracts, and one-third of premiums earned for property, casualty or health insurance contracts and 10 percent of the reserves for life insurance or annuity contracts. Qualifying insurance company and qualifying insurance company branch are defined in section 953(e). A critical component of section 953 insurance income and section 954 foreign personal holding company income, therefore, is the amount of insurance reserves determined under section 954(i).

Under section 954(i)(4)(B), the amount of the reserve for any life insurance or annuity contract is the greater of the net surrender value of the contract, as defined in section 807(e)(1)(A), or the reserve determined under section 954(i)(5). Under section 954(i)(5), the amount of the reserve is "determined in the same manner" as it would be determined if the qualifying

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insurance company were subject to tax under subchapter L, with specific rules for interest rates and mortality and morbidity tables. The applicable federal interest rate is replaced with an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable federal interest rate (AFR (within the meaning of section 1274(d)). The prevailing state assumed rate is replaced with the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country are used in lieu of U.S. mortality and morbidity tables.

In certain instances, a CFC can use its foreign statement reserves for purposes of determining its reserve for life insurance or annuity contracts. The CFC must obtain a ruling from the Service that the factors taken into account in determining the foreign statement reserve (less any catastrophe, deficiency, equalization, or similar reserves) provide an appropriate means of measuring income; the amount of the reserve is the foreign statement reserve. The Service's approval is based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for federal income tax purposes. The CFC is required to provide the Service with information as to the method, interest rate, mortality and morbidity assumptions, and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under subchapter L.[2]

FACTS AND CONCLUSION OF THE RULING

Parent engages in the insurance business both domestically and internationally through its subsidiaries. Parent, through a wholly owned U.S. subsidiary, holds all the stock of insurance subsidiaries operating in foreign countries, "the CFCs," which all operate in Country A. Country A government agency (the Agency) regulates the insurance industry in that country. The CFCs file annual reports and financial statements with the Agency that are audited by outside auditors, are subject to inspection by the Agency, and are made available to the public. The CFCs use these reports for financial, as well as regulatory, purposes. In accordance with Country A's rules for life insurance companies, the CFCs each set forth on their license application the computation method for their underwriting reserves, which must conform to the standards prescribed by the Agency. Any change to the method requires advance notice to the Agency. Country A's laws also require the CFCs to establish and maintain certain reserves (underwriting reserves and loss reserves) for obligations to holders of their life insurance and annuity contracts and to set forth the amount of such reserves on the annual reports. The Agency requires the CFCs to hold underwriting reserves to secure the performance of obligations arising in the future from the life insurance and annuity contracts. The CFCs are also required by the Agency to maintain loss reserves for outstanding claims (including incurred but not reported claims) under life insurance and annuity contracts. The CFCs calculate loss reserves using the company's individual experience, in accordance with the Agency's rules. In compliance with Country A's rules, the CFCs have each appointed a qualified actuary to be involved in any actuarial matters, including the method of calculating reserves. The actuary is required to submit reports to the board of directors and to the Agency on the actuarial soundness of the CFCs' reserves.

In concluding that the underwriting reserves used in the foreign statements of the CFCs can be used to determine subpart F income under section 954(i)(4)(B)(ii), the Service cited the following reasons:

1. The CFCs must establish, maintain and calculate their underwriting reserves in accordance with the insurance laws and regulations of Country A and guidance prescribed by the Agency.
2. The Agency generally requires a life insurance company to determine the amount of its underwriting reserves under the net level premium method. The Agency allows the CFCs to calculate their underwriting reserves under the Zillmer method provided they also maintain special risk reserves for mortality and investment risk. The CFCs hold reserves under the net level premium method and the Zillmer method. The Zillmer reserve and the special risk reserves required by the Agency when the Zillmer method is used are less than the underwriting reserve that would need to be maintained if they were determined under the net level premium method.[3]

3. The CFCs must set forth their underwriting reserves on the Annual Reports, which must be filed annually with the Agency. As such, these reserves are the measure of the legal obligations to contractholders on the financial statement used for regulatory purposes by life insurance companies doing business in Country A.
4. The Agency requires the CFCs to hold their underwriting reserves to enable them to fulfill claims owed to contractholders and their beneficiaries.
5. The underwriting and risk reserves are not catastrophe, deficiency, equalization, or similar reserves.

The Service also determined that the loss reserves held by the CFCs , *i.e.,* losses payable, are foreign statement reserves within the meaning of section 954(i)(4)(B)(ii), for the following reasons:

1. The CFCs must establish, maintain and calculate loss reserves in accordance with the insurance laws and regulations of Country A and guidance issued by the Agency.
2. The CFCs must set forth their loss reserves on the Annual Reports, which must be filed annually with the Agency. As such, they are the measure of the legal obligations to the contractholders on the financial statement used for regulatory purposes by life insurance companies doing business in Country A generally (whether U.S.-owned, locally owned, or owned by companies headquartered in other foreign countries).
3. The Agency requires the CFCs to hold loss reserves for the fulfillment of the claims of contractholders and their beneficiaries.
4. The CFCs' loss reserves are not catastrophe, deficiency, equalization, or similar reserves.

The Service noted that it was not expressing an opinion regarding whether some or all of the risk reserves would constitute foreign statement reserves within the meaning of section 954(i)(4)(B)(ii) when the risk reserves cause total underwriting reserves to exceed the standard valuation reserve using the reserve method prescribed by the Agency. The Service also noted that the rulings are solely that certain foreign reserves are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) and for no other purpose.

IMPLICATIONS OF THE RULING

Reserves as determined under section 954(i) are a critical component of subpart F income of a CFC that is engaged in the insurance business. For a variety of reasons, CFCs may not focus on the determination of reserves as required by section 954(i). As investments in foreign insurance operations continue to grow and become more significant to the investor, the need for accurately determining subpart F income becomes more important. Also, the taxation of actual or deemed distributions is dependent on accurately determining subpart F income and earnings and profits.

There are two basic methods of determining reserves under section 954(i): (1) recalculate the reserves of the CFC in accordance with the rules as laid in section 954(i)(4), or (2) obtain approval from the Service via a private letter ruling to use the CFC's local statutory reserves. Recalculation of the reserves requires a substantial amount of work and typically results in a reserve that is lower than the reserve used on the financial statements of the CFC. While no prior approval from the Service is required, the recalculation of the reserves is subject to examination by the Service at a later date. Obtaining the Service's approval to use financial statement reserves requires substantial correspondence with the Service. While the Service pre-approves the use of the financial statement reserves, the correspondence with the Service and factual basis for the approval of the Service may be subject to examination.

In order to determine reserves under section 954(i) or for earnings and profits purposes, a taxpayer must have extensive actuarial expertise and knowledge of the section 807 reserving requirements and a thorough understanding of the insurance products being sold by the CFC, the business and accounting processes used by the CFC in accounting for those products, and how the products are regulated and taxed by the local authorities.

The views expressed are those of the author and not of Ernst & Young LLP.

END NOTES

[1] *See* PLRs 200327052, 200341019 and 200709049.
[2] *See* Staff of the Joint Comm. on Taxation, Technical Explanation of the "Job Creation and Worker Assistance Act of 2002" (JCX-12-02 (March 6, 2002)).
[3] Broadly speaking, a "Zillmer" reserve method is a "modified" net premium reserve with an allowance for expenses in the net premium. The Commissioners Reserve Valuation Method (CRVM) is a form of "Zillmer" reserve. Outside of the United States, preliminary term reserves are often referred to as "Zillmerized reserves."

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RECENT CASES ON CHANGES FROM ERRONEOUS ACCOUNTING METHODS—DO THEY APPLY TO CHANGES IN BASIS OF COMPUTING RESERVES?

By Peter H. Winslow and Brion D. Graber

A special rule applies when a life insurance company changes its basis of computing reserves. Section 807(f) of the Internal Revenue Code imposes a "10-year spread" under which the difference between the tax reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change is reflected ratably over 10 years. In general, the 10-year spread rule of section 807(f) is applicable only when there otherwise would be a change in method of accounting under general tax law principles.[1] Although the same type of events will trigger the 10-year spread rule and a change in method of accounting, there are four important differences in their consequences.

First, Internal Revenue Service ("IRS") consent is not a prerequisite for recognizing a change in basis of computing reserves for tax purposes as it is for a change in method of accounting.[2] Second, a change in method of accounting is fully implemented in the year of change, with the opening and closing items for that year computed under the new method. Under the 10-year spread rule, only reserves for contracts issued in the year of change are determined under the new method; contracts issued in prior years remain on the old method until the succeeding year, when the opening and closing balances are computed using the new method. Third, a taxpayer changing its method of accounting from an erroneous method is not permitted to go back and correct the tax return for the first year in which the erroneous method was adopted unless the IRS agrees to the change.[3] Under the 10-year spread rule, a taxpayer changing from an erroneous method of computing reserves is permitted, but apparently not required, to make the correction in the earliest year open under the statute of limitations.[4] Finally, when a change in method of accounting is made, a taxpayer generally must reflect the difference between the old and new method's opening balances in taxable income all at once as a "481 adjustment,"[5] although the IRS may provide for a spread of a net positive 481 adjustment as a condition of granting its consent to the change.[6] Under the 10-year spread, the difference between opening reserves under the old and new methods for the taxable year succeeding the year of change is spread ratably over 10 years.

The application of section 807(f) to tax reserve changes is discussed at length in an article in the February 2010 *Taxing Times*.[7] Since that article, two court cases have come out dealing wth change-in-method-of-accounting issues. In both cases, the taxpayers had been on an erroneous method and either the IRS or the taxpayer sought a change to a correct method. We thought it might be interesting to review the courts' conclusions in these cases to examine whether or how they may apply to changes in basis of computing reserves to correct errors.

BOSAMIA[8] —DECIDED OCT. 24, 2011

The taxpayers in this case were the sole shareholders of two Subchapter S corporations, India Music and HRI. Over the course of seven years, India Music purchased inventory from HRI on account, but never made any payments to HRI. India Music accounted for these purchases using the accrual method of accounting, with the result that it claimed deductions when the purchases were made, not when it made payments to HRI. HRI accounted for these same transactions using the cash method of accounting, with the result that it reported no income from these transactions because it received no payments from India Music.

The IRS disallowed India Music's deductions from the related-party transactions with HRI for the 2004 tax year. The IRS relied on section 267(a)(2), which prohibits one party from claiming a deduction as a result of a transaction with a related party until the related party recognizes the income from the

transaction. The IRS treated this deduction denial as a change in India Music's method of accounting under section 481. To prevent India Music from having an omission of income as a result of this change, the IRS made a 481 adjustment to India Music's 2004 tax year that increased its income in that year by the amount of the deductions claimed by India Music in prior years relating to the related-party transactions with HRI.

At the time the IRS made the change to India Music's 2004 tax year, the first five years in which the related-party transactions had occurred were closed because the statute of limitations had run. Notwithstanding that fact, the taxpayers agreed that if the section 267(a)(2) disallowance was a change in method of accounting subject to section 481, the IRS's adjustment for 2004 to prevent an omission of income was proper. The taxpayers argued, however, that it was improper for the IRS to make them include any amount in income associated with the related-party transactions for the five closed years because the disallowance for 2004 under section 267(a)(2) was not a change in method of accounting. Instead, they argued, it was an audit adjustment to correct erroneous deductions for that tax year. The resolution to this dispute depended on whether the disallowance effected a change in India Music's timing treatment of a material item.

The Fifth Circuit agreed with the IRS's position, concluding that Congress plainly intended a disallowance under section 267(a)(2) to effectuate a change in a taxpayer's method of accounting. The Court noted that section 267(a)(2) provides for a matching of income and deductions by preventing the use of differing methods of accounting by related parties. Under applicable authorities, for the section 267(a)(2) disallowance to constitute a change in a method of accounting, it must involve a change in the treatment of a material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. The Court found that the IRS had effectively made precisely this type of change with respect to India Music's accounting for its inventory purchases from HRI by requiring India Music to wait to deduct the cost of those purchases until HRI recognized income from the transactions.

As a general matter, the Court's decision is not particularly remarkable. The specific issue addressed by the Court was one of first impression, but the holding is consistent with well-established judicial and administrative authorities. Nevertheless, the case is instructive in at least two respects in the context of changes in basis of computing reserves to correct errors. First, implicit in *Bosamia* is that India Music had adopted an erroneous method of accounting with respect to its purchases from HRI by treating that item in the same way on two or more consecutively filed returns.[9] In fact, India Music had treated the purchases in the same way on its tax returns for seven consecutive years. The adoption of this erroneous method of accounting ultimately necessitated the 481 adjustment when the IRS corrected India Music's method of accounting in the 2004 tax year. Similarly, an insurance company that uses an erroneous basis to compute its reserves is subject to 807(f), and its 10-year spread rule, if the erroneous basis is consistently applied from year to year.[10] As in *Bosamia*, it does not matter that the effect of the 10-year spread required by section 807(f) is to reverse erroneous deductions claimed in prior closed years. It also does not matter that the change is from a clearly erroneous method. When a tax reserve method has been consistently applied, a change from that method is subject to section 807(f) whether or not the prior method was correct. It is not merely a "correction of an error" for which the 10-year spread has no application. In this respect, *Bosamia* is consistent with the IRS's stated position that changes in reserve computations arising from inadvertent errors such as pure mathematical mistakes or computer programming defects "are limited to nonrecurring errors that affect the determination of the amount of a taxpayer's reserves only for a particular taxable year."[11]

Secondly, the taxpayers in *Bosamia,* were required to make the 481 adjustment in a single year, resulting in an increase in their income in that year equal to the full amount of the adjustment. If the case had instead involved a correction in the basis of computing reserves that required an increase in an insurance company's income, the increase relating to contracts issued prior to the year of change would have been spread over 10 years, beginning with the year following the year of change. This outcome under section 807(f) generally would be preferable to the one the *Bosamia* taxpayers experienced. If the required adjustment involved decreasing the taxpayer's income, however, recognizing the entire decrease in a single year as

Similarly, an insurance company that uses an erroneous basis to compute its reserves is subject to 807(f), and its 10-year spread rule, if the erroneous basis is consistently applied from year to year.

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required for a 481 adjustment might generally be preferable to being required to spread the decrease over 10 years under section 807(f).

CAPITAL ONE[12]—DECIDED OCT. 21, 2011

This case also involved a change from an erroneous method of accounting, although here the change was initiated by the taxpayer. The taxpayer, Capital One, earned a portion of its income from a variety of fees that it charged in connection with its credit card and other consumer-lending products. Capital One had historically reported the income from fees, including late fees charged to customers who did not pay on time, at the time that it charged the fees to its customers. Tax legislation enacted in 1997, however, extended original issue discount ("OID") treatment to certain credit card revenues. OID is included in income as interest over a debt instrument's duration, rather than entirely at the time it is issued or redeemed. The IRS issued a Revenue Procedure clarifying that taxpayers could obtain "automatic consent" to change accounting methods if they were affected by this new legislation and properly filed with the IRS a Form 3115, Application for Change in Accounting Method.[13]

Capital One filed a Form 3115 with its 1998 return indicating it proposed to account for various items as OID, but did not specifically mention late fees on the form. Capital One also reported income from the items identified on the Form 3115 on its tax returns for 1998 and 1999 as OID. Income from late fees, however, was reported as it had always been reported—as income when charged to customers. Subsequently, in connection with a lawsuit in the Tax Court involving a separate issue, Capital One sought to treat its income from late fees as OID for 1998 and 1999.

The Tax Court held that Capital One could not change how it accounted for late fees in 1998 and 1999. The Fourth Circuit affirmed the Tax Court's decision. The Fourth Circuit held that the change sought by Capital One could not be made without the consent of the Secretary, which was not granted. Such consent must be secured prior to calculating taxable income. To allow changes in methods of accounting without such consent would "roil the administration of the tax laws."

Capital One advanced several arguments in support of its position, none of which the Fourth Circuit found convincing. Capital One argued it was not subject to the consent requirement because it was correcting the use of an improper method, *i.e.,* merely correcting an error. The Court rejected that argument, citing multiple authorities concluding that consent is still required when changing from an improper to a proper method. Capital One also asserted that the 1997 legislation obviated the general consent requirement because it provided for automatic consent to a change in method of accounting to comply with the new OID rules. The Court responded that even under automatic consent, there are still procedures that taxpayers must follow to receive consent, including filing Form 3115, and Capital One did not do so in this case.

Capital One argued that it in fact filed a Form 3115 and met any procedural obligations that it had. The Court rejected that argument, however, because the consent procedures require that the Form 3115 specify all classes of material items that will be treated differently under the new method of accounting. The Form 3115 Capital One filed did not identify late fees as an item, although it did identify interest and OID. Capital One contended that the late fees were not a separate item but merely a component of OID, which itself was a component of interest. In other words, Capital One argued that for accounting-method purposes, interest was a single material item and late fees were merely a component of interest that needed to be conformed to the overall accounting method. The Court stated that using such a broad definition of material item would be inconsistent with the requirement to obtain consent for each item as it would be difficult to identify any other source of revenue that would qualify as an item, yet alone a material item, if the late fees did not. Late fees are Capital One's single largest fee-based source of revenue, are earned each year, are separately identified on Capital One's income statements, and are earned on a different basis than other fees.

The Court identified one additional reason for ruling against Capital One, which it referred to as "fatal" to Capital One's claim. Even if Capital One had received consent to treat the late fee income as OID, Capital One did not so treat it on the 1998 and 1999 returns it filed, but instead continued to report it as income when charged to customers. As noted above, it is well-established that a taxpayer elects an erroneous method of accounting by consistently treating a material item in two or more consecutively filed tax returns. In this case, Capital One treated the late fees as income when they were charged to customers on the tax returns it filed for 1998 and 1999. Thus, even if Capital One had consent to treat the late fees as OID

on its 1998 and 1999 returns, it did not do so, instead choosing to use an erroneous method, thereby nullifying any consent it argued it had received. Capital One's final argument was that its attempt to change how it accounted for late fees after it changed how it accounted for other fees was a mere error correction to account for all of the fees consistently. The Court dismissed this argument as well outside the error correction exception, which is limited to mathematical or posting errors.

As with *Bosamia, Capital One* allows for a couple of insights into changes in basis of computing reserves. In *Capital One*, the taxpayer attempted to make a change without IRS consent to correct an erroneous method of accounting in the earliest open year in which the erroneous method was used. The change was not allowed, however, because consent is required to make any method-of-accounting change, including changing from an erroneous method,[14] and method-of-accounting changes may not be made retroactively unless the IRS agrees to the change.[15] An insurance company desiring to correct an error in its basis for computing reserves has it easier for a couple of reasons. First, the company is not required to get IRS consent to the change, which means the company does not need to file a Form 3115 and does not need to concern itself with the possibility that the IRS may withhold its consent to the proposed change. Second, the company may make the change in the current year or, if it chooses (or the IRS so requires), go back and amend its earliest open year containing the error.[16]

The other insight is the Court's conclusion that late fees constitute a separate "material item" for accounting method purposes. In holding that the late fees constituted a material item that was distinct from interest and OID, the Court noted that the late fees were earned each year, were separately reported on Capital One's income statements, were earned on a different basis than Capital One's other fees, and were the largest source of fee revenue for Capital One. Therefore, late fees could have their own accounting method whether or not it was erroneous.

Application of section 807(f) also requires that there be a change to a material item in the tax return computation. It is clear that corrections to interest rate and mortality assumptions are separate material items, but other assumptions likely are as well. For example, changes in the assumptions as to when premiums are paid (*e.g.,* changing from the assumption that they are received annually in advance to the assumption that they are received according to the contract's premium mode), as to when claims are paid (*e.g.,* changing from the assumption that death benefits are paid at the end of the policy year in which death occurs to the assumption that they are paid in the middle of the policy year in which death occurs), and as to the age or sex of the insured (*e.g.,* changing from an assumed age or sex when the insured's exact age or sex are unclear to using the exact age or sex once precise information becomes available) all present similar considerations and may impact the proper time for the taking of a deduction by affecting the computation of reserves. The IRS is likely to contend that these changes are subject to section 807(f) even when they are correcting prior erroneous treatment.

CONCLUSION

As the preceding discussion makes clear, holdings in change-in-method-of-accounting cases can have significance in section 807(f) situations, but how the principles are implemented can be very different. In some cases, those differences may be beneficial to an insurance company faced with a change under section 807(f), such as the ability to make the change without IRS consent, and in other cases they may be adverse, such as the requirement to spread the effect of a change that reduces income over 10 years.

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END NOTES

1 *See* Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life & Accident Insurance Co. v. United States*, 71A A.F.T.R.2d 93-3319 (M.D. Tenn. 1989).

2 *See* I.R.C. § 446(e) (stating that consent generally is required to make a change of accounting method). Consent is required under section 446(e) even if the taxpayer wants to change from an erroneous method or one that does not clearly reflect income. *E.g., Witte v. Commissioner,* 513 F.2d 391 (D.C. Cir. 1975).

3 *Diebold v. United States,* 16 Cl. Ct. 193 (1989), *aff'd,* 891 F.2d 1579 (Fed. Cir. 1989); Rev. Rul. 90-38, 1990-1 C.B. 57. An erroneous method of accounting is adopted by consistently treating an item on two consecutive tax returns. *See, e.g.,* Rev. Rul. 90-38.

4 Rev. Rul. 94-74. If the IRS is making the change, it may require that the change be made in the earliest open year.

5 I.R.C. § 481; *Security Benefit Life Insurance Co. v. United States,* 517 F. Supp. 740 (D. Kan. 1980), *aff'd,* 726 F.2d 1491 (10th Cir. 1984).

6 *See* Rev. Proc. 2002-19, 2002-1 C.B. 696 (providing a four-year adjustment period for a net positive adjustment and a one-year period for a net negative adjustment when the taxpayer has properly requested IRS consent to the change in accounting method).

7 Peter H. Winslow & Lori J. Jones, *Change in Basis of Computing Reserves—Is It or Isn't It?* Taxing Times, Feb. 2010, at 9.

8 *Bosamia v. Commissioner,* 661 F.3d 250 (5th Cir. 2011).

9 *See, e.g.,* Rev. Rul. 90-38, 1990-1 C.B. 57.

10 *See* Rev. Rul. 94-74, 1994-2 C.B. 157; Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error* (Jan. 6, 1997).

CONTINUED ON **PAGE 56**

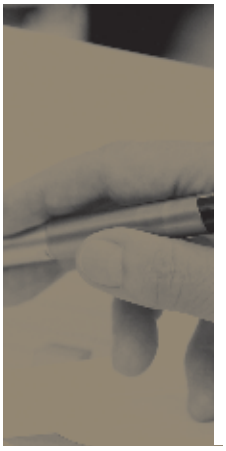
END NOTES CONT.

[11] Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error.*
[12] *Capital One Financial Corp. v. Commissioner*, 659 F.3d 316 (4th Cir. 2011).
[13] Form 3115 is the form that taxpayers requesting a change in method of accounting must file with the IRS to obtain consent to the change. It provides information about the taxpayer and the proposed change. The form is required whether the change is requested pursuant to an automatic consent procedure or an advance consent procedure. Even when the form is properly filed, the IRS may request that the taxpayer provide additional information and may decide not to give its consent.
[14] Section 446(e); Treas. Reg. § 1.446-1(e).
[15] *Diebold v. United States*, 16 Cl. Ct. 193 (1989), *aff'd*, 891 F.2d 1579 (Fed. Cir. 1989); Rev. Rul. 90-38, 1990-1 C.B. 57.
[16] Rev. Rul. 94-74, 1994-2 C.B. 157; Coordinated Issue Paper, *IRC Section 807 Basis Adjustment—Change in Basis v. Correction of Error* (Jan. 6, 1997).

ACLI UPDATE

BILL TO REQUIRE TAX REPORTING OF SALES OF INTERESTS IN LIFE INSURANCE POLICIES

By Mandana Parsazad, Pete Bautz and Walter Welsh



On March 14, the Senate passed S. 1813, the "Highway Investment, Job Creation, and Economic Growth Act of 2012" ("Highway Bill") by a 74-22 vote. The bill contained a provision that requires tax reporting of sales of interests in life insurance policies. We understand the provision is identical to the bill introduced by Senator Robert Casey in January of this year. Senator Casey's bill S. 2048, "A bill to amend the Internal Revenue Code of 1986 to clarify the tax treatment of certain life insurance contract transactions, and for other purposes" tracks very closely the legislative language the American Council of Life Insurers (ACLI) and its member companies developed over the past year and a half.

Senator Casey's bill would require the buyer of an interest in a life insurance policy to report the sale to the Internal Revenue Service ("IRS") and notify the life insurer that issued the policy. Upon notification of the sale by the purchaser, the life insurer is required to report the investment in the contract to the seller and the IRS. The insurer is also required to report the death benefit subsequently paid with respect to the life insurance policy.

Most notably, the Casey bill would amend section 1016 of the Internal Revenue Code by adding a subsection that would confirm the basis in the life insurance contract is not adjusted by cost of insurance charges. In Rev. Rul. 2009-13, the IRS concluded that the insured-seller's basis in a life insurance contract should be adjusted by subtracting the cost of insurance charges from the investment in the contract. This bill would confirm the longstanding rule and the industry's position that investment in the contract is not reduced for mortality, expense, or other reasonable charges incurred under the life insurance contract.

The fate of the Senate Highway Bill and its provisions is unknown as of the date of this article's submission. The House may accept the Senate's bill, amend it, or suggest a temporary extension of the current law. Federal funding for transportation projects will expire on March 31 unless a bill or an extension of the current funding is enacted by that date.

CHAIRMAN CAMP'S DISCUSSION DRAFT FOR A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME

In October 2011, Ways & Means Chairman David Camp released a Discussion Draft for international tax reform that proposes a territorial system for taxation of international income ("Discussion Draft"). Chairman Camp asked specific questions on the content of the Discussion Draft and invited comments on how certain unaddressed issues should be treated in a territorial system.

Our member companies have been studying the various forms of territorial systems for taxing international income since February 2011 and assessing how life insurers might be affected. ACLI identified some key areas of concern for life insurers, including:

- Treatment of income related to active conduct of life insurance as active;
- Transition rules that unfairly penalize life insurance companies; and
- Increased complexity.

Based on this work, the ACLI prepared preliminary comments on Chairman Camp's Discussion Draft. The ACLI letter addresses the treatment of income from the active conduct of life insurance business and some transitional issues that are important but not necessarily unique to life insurance companies.

Noting that the Discussion Draft does not change the rules for taxation of foreign personal holding company income under subpart F, and more specifically the rules for determining income derived in the active conduct of insurance

CONTINUED ON **PAGE 58**

business, ACLI observed that any reform should continue to exempt active financial service income from subpart F on a permanent basis. The parameters set for defining active life insurance income should take into full consideration the fact that a life insurance company's investment operations are an integral part of its life insurance business and its investment income is dedicated to the underwritten risks and obligations of that business.

ACLI also identified transitional issues raised by the Discussion Draft. These include:

- The effect of the 5.25 percent transition for industries that may only operate in per-se corporate form overseas;
- The tax treatment of proposed reclassification of foreign partnerships and branches as controlled foreign corporations;
- Exclusion of pre-acquisition earnings and profits when a taxpayer had not made a 338(g) election;
- Prospective application of the Discussion Draft's loss disallowance rule where losses are the result of business activity before the effective date of any new rules;
- Definition of earnings and profits for purposes of transitional rule; and
- Potential for double taxation of passive foreign income that is considered distributed under proposed section 245A of the Discussion Draft prior to the passage of this section's one-year holding period requirement.

ACLI staff and member company representatives are planning to meet with Ways & Means staff to share these preliminary comments on the Discussion Draft.

FOREIGN ACCOUNT TAX COMPLIANCE ACT ("FATCA")

The proposed regulations to implement the Foreign Account Tax Compliance Act ("FATCA"), enacted as part of the Hiring Incentives to Restore Employment Act,[1] were released by Treasury and IRS on Wednesday, Feb. 8. FATCA requires that "foreign financial institutions"[2] ("FFIs") obtain and report information with respect to any financial account which is held by a U.S. person. Failure to enter into an agreement with the Secretary of Treasury results in a 30 percent withholding tax on any U.S.-source withholdable payment to the FFI.[3]

ACLI and its member companies will be analyzing these proposed rules to identify the issues for life insurers and life insurance products for comment and clarification. Below is a highlight of the proposed rules for life insurance companies and products.

The proposed regulations include life insurance companies as financial institutions for purposes of Chapter 4. Thus life insurance companies that issue life insurance or annuity contracts with any cash value would be financial institutions and subject to Chapter 4. ACLI requested that foreign life insurance companies that issue only life insurance contracts without cash value, such as all life reinsurance contracts, term life, return of premium, medical and disability, and other protection insurance policies, or issue contracts that fit the following criteria, not be treated as FFIs:

- $50,000 or less in cash value;
- $10,000 or less in annual premiums;
- Contracts for which the investment return does not exceed the premiums and other amounts paid for the contract during the first 10 years;
- Contracts with death benefits of $500,000 or less.

The proposed regulations exclude pre-existing and newly issued term life insurance from the definition of a financial account.[4] The Detailed Descriptions of the proposed regulations explain that "insurance contracts that provide pure insurance protection (such as term life, disability, health, and property and casualty insurance contracts)" are excluded from the term financial account. ACLI requested that life insurance or annuity contracts without cash value, all life reinsurance contracts, term life, return of premium,[5] medical and disability, and other protection insurance policies should not be treated as financial accounts as they present no tax evasion risk. The proposed regulations do not specifically address life reinsurance.

The proposed regulations also exclude pre-existing and newly issued retirement or pension accounts from the definition of a financial account. ACLI requested that retirement plans be exempted from FATCA because they pose a low risk of tax evasion.

The proposed regulations exclude from the due diligence procedures pre-existing life insurance and annuity contracts with cash values of $250,000 or less. For these pre-existing accounts, the foreign financial institution will be required to perform due diligence when the account balance or value ex-

ceeds $1,000,000.[6] For pre-existing life insurance and annuity contracts with cash values of $250,000 and more, the rules require the foreign life insurance company to conduct an electronic search of their files for indicia of U.S. policyholders. For policies with cash values in excess of $1,000,000, a manual search of the files for indicia of U.S. policyholders is required. Also, actual knowledge of U.S taxpayer status by a relationship manager associated with the account must be included in the review of these accounts.

The proposed regulations define financial account to include any life insurance or annuity contract with cash values above zero as subject to Chapter 4 reporting.[7] They define cash value as: "the greater of—

1. The amount that the policyholder is entitled to receive upon surrender or termination of the contract (determined without reduction for any surrender charge or policy loan); and
2. The amount the policyholder can borrow under or with regard to the contract."[8]

ACLI requested de minimis exceptions and advocated for the use any of the following criteria to exclude newly issued contracts from Chapter 4 requirements:

- $50,000 or less in cash value,
- $10,000 or less in annual premiums,
- Investment returns that do not exceed the premiums and other amounts paid for the contract during the first 10 years; or
- Death benefit of $500,000 or less.

We continue to consider a need for a de minimis rule and a more appropriate definition of cash value.

Finally, ACLI 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.

END NOTES

1 Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (the "HIRE" Act).
2 Sections 1471(d)(5), 1471(a) and (b).
3 Withholdable payments are defined in section 1473(1) as "any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits, and income, if such payment is from sources within the United States, and … any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States."
4 Prop. Treas. Regs. §1.1471-5(b)(2)(ii).
5 Contracts may provide for returning of a portion of the premium up to 100 percent of the premium.
6 Prop. Treas. Regs. §1.1471-4(c)(4)(iv).
7 Prop. Treas. Regs. §1.1471-5(b)(3)(v). The definition of "custodial accounts" also includes insurance or annuity contract. *See*, Prop. Treas. Regs. §1.1471-5(b)(3)(ii).
8 Prop. Treas. Regs. §1.1471-5(b)(3)(v)(B).

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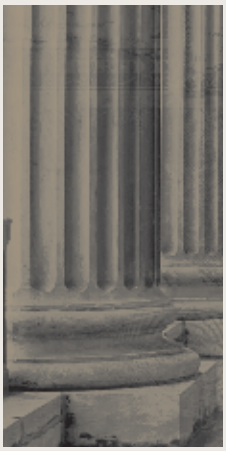

T3: *TAXING TIMES* TIDBITS

THE BENEFIT OF THE BARGAIN: IRS CHALLENGES TO SETTLEMENT ALLOCATIONS

By Kevin T. Leftwich

Sometimes you need to be careful what you bargain for. The corporate taxpayer in *Healthpoint Ltd. v. Commissioner*[1] learned this lesson the hard way after the Tax Court held that the company could not recast a jury award of punitive damages as "damage to goodwill and reputation" in a final settlement agreement. The holding prevented the taxpayer from characterizing the reallocated amount as capital gains instead of ordinary income. In reaching its decision, the court found that the allocation of damages in the settlement agreement was not reached through an adversarial process but instead was designed specifically to allow the taxpayer to treat the damages as capital gains. Adding insult to injury (or, as the case may be, penalties to damages), the court found the taxpayer liable for substantial understatement penalties under I.R.C. §6662(a). The case teaches important lessons for insurance companies that participate in drafting settlement agreements designed to achieve favorable tax treatment of the settlement payments.

The general rule is that the tax treatment of a settlement depends on the nature of the claims being settled.[2] The allocation contained in a settlement agreement will usually be respected for federal tax purposes if the agreement was reached through an adversarial, arm's-length process.[3] However, it is accepted that an allocation is not controlling where facts indicate that the allocation is inconsistent with the parties' actual economic intentions underlying the settlement.[4]

Healthpoint, Ltd., ("Healthpoint") received a jury award against Ethex Corporation ("Ethex") at the end of litigation concerning Ethex's marketing of an ineffective product as a generic version of one of Healthpoint's products. The jury awarded Healthpoint $16.1 million, $3.1 million of which was characterized as punitive damages. Ethex appealed. Additionally, prior to the jury's decision in the first litigation, Healthpoint filed a second suit relating to a different product sold by Ethex.

Healthpoint and Ethex negotiated extensively to settle the two suits before the first case was decided on appeal and before a jury decision in the second, and eventually agreed to a global settlement covering all claims from both cases. Healthpoint and Ethex agreed to settle for a total of $16.5 million— $12 million for the first suit and $4.5 million for the second. Healthpoint proposed allocating $1.1 million of the proposed settlement to punitive damages, as opposed to the $3.1 million in punitive damages awarded by the jury in the first litigation. Ethex, however, rejected the proposal and indicated that it would not agree to *any* allocation that characterized the company's actions as "willful misconduct." Healthpoint, believing that Ethex would not agree to any settlement that included punitive damages, agreed to an allocation that did not include any punitive damages.

The Internal Revenue Service (IRS) examined Healthpoint's tax return and challenged the characterization of the majority of the settlement amount as long-term capital gains. The IRS argued that the allocation of damages made by the jury should be applied to the settlement amount to determine its character for tax purposes, resulting in a significantly larger portion of the payment being ordinary income. The IRS further argued that the reallocation resulted in a substantial understatement and that a 20 percent penalty under I.R.C. §6662(a) should apply. The Tax Court, in interpreting the judicial precedent regarding the level of deference to be given to settlement allocations, stated that deference "is not warranted where circumstantial factors reveal that the designation of the settlement proceeds was not the result of adversarial, arm's-length and good faith negotiations and is incongruous with the 'economic-realities' of the taxpayer's underlying claims."[5]

The court was not persuaded by Healthpoint's argument that Ethex's refusal to agree to Healthpoint's proposed allocation of punitive damages was proof that the allocation was the product of adversarial, arm's-length negotiations. Instead, the court reasoned that Ethex's willingness to recharacterize the original punitive-damages award without decreasing the total settlement amount indicated that Ethex was not opposed to paying punitive damages; it merely refused to label the damages as punitive. The court further reasoned that, although Healthpoint and Ethex were clearly adverse with regard to their opposing claims and the amount of the settlement, their interests were not at odds with respect to the allocation of the settlement. Additionally, the court concluded that Healthpoint was motivated to agree to the final allocation because of tax considerations. The resulting settlement, therefore, according to the court, deviated from the "economic-realities" of the underlying claims. Because the settlement agreement should not be respected, the court determined that the best way to allocate the settlement amount was based on the percentages set forth in the original jury award.

Despite the citation of cases supporting the argument that settlement allocations should be respected for tax purposes, the court determined that Healthpoint's position was not adequately supported by substantial authority. Additionally, the court held that Healthpoint failed to show that it relied on the advice of tax counsel that the allocation was reasonable. As a result, the accuracy-related penalties of 20 percent were affirmed.

Taxpayers engaged in future settlement negotiations should heed the lessons learned from this ruling. Because tax consequences should be an important consideration in all settlement negotiations, and because a reallocation by the IRS can significantly alter the economics of the agreement the taxpayer anticipated receiving, it is important for taxpayers to evaluate whether the settlement allocation and, thus, the resulting tax treatment, is reasonable. Bringing the lessons learned from the *Healthpoint* case to the negotiating table hopefully can ensure that future taxpayers get the benefits they believed they bargained for. It is also important, however, to consider whether an allocation contained in an agreed-upon settlement should always form the basis of the recipient's return position (or an insurance company's Form 1099 information reporting position). The court's decision to uphold the substantial understatement penalty should motivate taxpayers to ensure that they have considered not only the settlement allocation, but also the subsequent tax positions taken based on the settlement. After all, a 20 percent substantial understatement penalty certainly was not one of the benefits Healthpoint believed it had bargained for.

END NOTES

1 T.C. Memo 2011-241.
2 United States v. Burke, 504 U.S. 229, 237 (1992); Robinson v. Commissioner, 102 T.C. 116, 126 (1994); Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944).
3 Robinson, *supra* note 2, at 126.
4 Bagley v. Commissioner, 105 T.C. 396, 406 (1995).
5 Healthpoint, Ltd. v. Commissioner, T.C. Memo 2011-241, at 1647.

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TAX HEDGE ACCOUNTING MATCHING PRINCIPLES AND REVENUE RULING 2002-71

By Peter H. Winslow and Samuel A. Mitchell

Tax hedge accounting is one area of life insurance tax law that is not well understood. There are several reasons for this, not the least of which is limited Internal Revenue Service (IRS) guidance and the fact that in many companies the investment department and risk managers do not communicate well with the tax department. The purpose of this article is to clear up some common misconceptions about the matching requirement for tax hedge accounting as interpreted by one of the few relevant revenue rulings. In the authors' experience, the matching principle frequently is misapplied by IRS agents on audit and by life insurance companies themselves.

What Qualifies as a Tax Hedge?

In general, realized gains and losses on financial instruments must be recognized for tax purposes, unless the instrument is part of a hedging transaction as defined in the Internal Revenue Code and regulations.[1] Gain and loss relating to a derivative that is part of a tax hedging transaction must be accounted for as ordinary income or loss in a manner that clearly reflects income.[2] A hedging transaction for tax purposes includes a transaction that a taxpayer enters into in the normal course of its trade or business primarily to manage the risk of (1) price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, or (2) interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.[3] Whether a

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transaction manages a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction.[4] A taxpayer's hedging strategies and policies, as reflected in its business records, are evidence of whether a hedging transaction manages risk.[5] The general test for whether there is risk management is determined at the macro level. Thus, a hedging transaction designed to manage risk with respect to a particular ordinary asset or liability generally is treated as a tax hedging transaction only if it also manages overall risk of the taxpayer's operations.[6]

Several other observations about the tax hedge qualification rules are worth noting. First, a qualified hedging transaction includes a hedge of an anticipatory acquisition of an ordinary asset or issuance of a liability. Second, tax hedge treatment can apply even if the hedge is for less than all the risk or for less than the entire period of the risk.[7] Third, unless a separate company election is made, the determination of whether a transaction qualifies as a tax hedge is made by treating all members of a consolidated tax return as if they were divisions of the same company.[8] Fourth, there are same-day tax hedge identification requirements that must be satisfied.[9] Finally, and significantly for life insurance companies, it is the IRS's position that whether a so-called "gap hedge" qualifies as a hedge of ordinary liabilities is a question of fact and depends on whether the hedge is more closely associated with liabilities than with capital assets. This more closely associated standard is not found in the Code or regulations, but only in the preamble to Treas. Reg. § 1.1221-2(b), and has led to much controversy in recent years.[10]

There are several advantages of tax hedge qualification: Regulated futures that are part of a tax hedging transaction are not required to be marked to market under I.R.C. § 1256;[11] the character of gain and loss on the hedging instrument is ordinary rather than capital; and a tax hedging transaction is not subject to the straddle rules of I.R.C. § 1092, under which losses realized on the disposition of a straddle position generally are deferred to the extent of unrecognized gain in positions open at year-end.[12] Most important for purposes of this tidbit, tax hedge qualification requires the adoption of an accounting method that clearly reflects income.

Tax Hedge Accounting

Treas. Reg. § 1.446-1(a) sets forth the general tax accounting rule and provides that, although no uniform method of accounting applies to all taxpayers, no method of accounting is acceptable unless, in the opinion of the IRS, it clearly reflects income. The requirement to clearly reflect income is reiterated specifically for tax hedges in Treas. Reg. § 1.446-4(b). The regulation states that clear reflection of income is achieved by matching, as follows:

> To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

The regulations go on to provide flexibility in choosing an appropriate tax hedge accounting method as long as it satisfies the matching principle. They state that different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. However, once a taxpayer adopts a method of accounting, that method must be applied consistently and can only be changed with the consent of the IRS.[13]

To comply with the regulations, the objective of a tax hedge accounting method should be to clearly reflect income by matching the timing of tax recognition of gains, losses, income and deductions attributable to the hedging instruments with the tax recognition of comparable items attributable to the hedged item. The regulations contemplate that ordinary tax rules will apply to the hedged item with the timing of recognition of gain/loss, etc., relating to the hedging instrument adjusted to match the hedged item. Thus, the regulations provide, in general, that tax accounting for the hedging instrument will supersede accounting rules that otherwise would apply under regulations so that proper matching to clearly reflect income occurs.[14]

Rev. Rul. 2002-71

Perhaps the most often misunderstood IRS guidance on the tax hedge accounting matching principle is Rev. Rul. 2002-71.[15]

In that ruling, a taxpayer issued a 10-year debt instrument and acquired a derivative with a five-year term that effectively converted the fixed rate payments on the debt into floating rate

payments. In accordance with Treas. Reg. § 1.446-4(e)(4), the hedge was accounted for as if it had adjusted the yield over the first five years of the hedged debt. In the ruling's Situation 1, the taxpayer terminated the derivative at the end of the second year. The issue addressed in the ruling was how to account for the termination payment. The IRS concluded that the gain or loss arising from the termination should be accounted for over the remaining period to which the terminated hedge relates.

Some taxpayers and IRS agents have relied on this ruling to conclude that gain or loss on derivatives that are terminated should always be spread over the period that the derivative would otherwise have been outstanding, but this is not what the ruling says or means. In the ruling, the termination payments were properly reflected over what would have been the remaining five-year term of the derivative, but that is only because the hedge related only to the first five years of risks relating to the hedged 10-year debt.

For many hedges routinely entered into by life insurance companies, the facts are not the same as in Rev. Rul. 2002-71. For example, suppose a company has a block of immediate annuity obligations with a duration of 10 years that the company would like to shorten. It decides to hedge the aggregate interest rate risk of the block of liabilities and selects a two-year receive-fixed/pay-floating interest rate swap with a notional amount that is greater than the present value of the annuity obligations. If the swap is terminated after one year at a gain or loss, Rev. Rul. 2002-71 does not support the conclusion that the gain or loss should be recognized in full in year two—when the swap otherwise would have terminated. Instead, because the hedge related to the aggregate interest rate risk in the hedged liabilities, it should be matched to the tax recognition of the entire hedged liabilities—probably a spread over the remaining nine-year duration of the liabilities. In short, a clear reflection of income requires a matching of gain or loss on a terminated hedge to the tax recognition of the hedged risks, whether or not that is the same as the remaining term of the hedge. Rev. Rul. 2002-71 does not hold otherwise.

END NOTES

1 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(b).
2 Treas. Reg. § 1.446-4.
3 I.R.C. § 1221(b)(2); Treas. Reg. § 1.1221-2(b).
4 Treas. Reg. § 1.1221-2(c)(4).
5 Treas. Reg. § 1.1221-2(c)(4).
6 Treas. Reg. § 1.1221-2(d)(1)(ii).
7 Treas. Reg. § 1.1221-2.
8 Treas. Reg. § 1.221-2(e)(1).
9 Treas. Reg. § 1.1221-2(f).
10 T.D. 8555, 1994-2 C.B. 180. A typical gap hedge seeks to close a duration gap between liabilities and assets (which may be capital) that are held to fund the liabilities. Because the company's risk primarily relates to the company's ordinary liabilities, one would think that the hedge should qualify as a tax hedge under I.R.C. § 1221(a)(7) whether or not capital assets also are considered in the hedge program. But, as indicated in the regulations' preamble, the IRS disagrees at least in some cases where the hedge is more closely associated with the capital assets funding ordinary liabilities.
11 I.R.C. § 1256(e).
12 I.R.C. § 1092(e).
13 Treas. Reg. § 1.446-4(c).
14 Treas. Reg. § 1.446-4(a).
15 2002-2 C.B. 763.

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