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CHAIRMAN CAMP'S TAX REFORM DISCUSSION DRAFT: WHAT DOES IT MEAN TO THE LIFE INSURANCE INDUSTRY?

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On Feb. 26, 2014, House Ways and Means Committee Chairman Dave Camp (R-MI) released a comprehensive tax reform discussion draft ("Discussion Draft") as part of his ongoing tax reform effort.[1] The legislative language that constitutes the Discussion Draft totals 979 pages and builds on the Committee's prior work on tax reform. The Discussion Draft incorporates proposals included in prior discussion drafts released by Camp focused on international tax reform (released Oct. 26, 2011), financial products tax reform (released Jan. 24, 2013), and small business tax reform (released March 12, 2013). The package of proposals included in the Discussion Draft is intended to lower tax rates, simplify the tax code, and strengthen the economy.[2]

Several documents related to the Discussion Draft were also released, including a Ways and Means Committee section-by-section summary[3] and a Joint Committee on Taxation (JCT) technical explanation that is divided into eight parts (one for each title of the Discussion

CONTINUED ON PAGE 2

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Draft).[4] In addition, two JCT revenue estimates were released—one estimate was prepared using the JCT's traditional estimating procedures and the second considered the macroeconomic effects of the proposal (popularly referred to as "dynamic scoring"). The traditional revenue estimate shows the Discussion Draft would increase revenue by approximately $3 billion over the 10-year budget window.[5] The dynamically scored estimate shows the Discussion Draft would increase revenue by $50 billion to $700 billion over the 10-year budget window depending on the modeling assumptions used, increase gross domestic product (GDP) by up to $3.4 trillion (which is equal to about 20 percent of current GDP), and create up to 1.8 million new jobs.[6] Finally, a distributional analysis prepared by the JCT was released.[7] The JCT revenue estimates and distributional analysis support Camp's goal that the proposals would provide revenue and distributional neutrality. But, the revenue neutrality is not achieved on an industry-by-industry basis and relies on what could be considered onerous phase-in and transition rules, as well as on revenue estimates that are limited to 10 years.

It is unlikely that the Camp proposals will be enacted this year and equally unlikely that they will survive intact when, and if, comprehensive corporate tax reform occurs, but the Discussion Draft undoubtedly will be considered by congressional tax-writing committees and policymakers as a starting place for tax reform discussions. For this reason, the Discussion Draft has important implications for life insurance companies, and the editors of *TAXING TIMES* have decided to devote a special edition to this development.

HOW TO ANALYZE THE DISCUSSION DRAFT'S IMPACT ON LIFE INSURANCE COMPANIES

Adoption of the Discussion Draft would have a profound effect on the life insurance industry. Based on our discussions with life insurance company tax professionals, it appears that the insurance industry generally favors the Discussion Draft's overall objective of lowering the corporate tax rate while broadening the tax base by eliminating unnecessary tax expenditures. Even if there is a reduced tax rate, however, no tax reform effort should eliminate tax provisions that are needed to avoid over-taxation of corporate earnings. There is nearly universal agreement in the insurance industry that the Discussion Draft fails in that basic tax reform test.

Another way to analyze the potential impact of the Discussion Draft on the life insurance industry is to weigh the benefits provided by the Discussion Draft against the various burdens it imposes—to see whether the industry is paying a disproportionate share as the price for tax reform. On this measure, indications are that the life insurance industry would lose far more as a result of the base-broadening provisions than it would gain from the corporate rate reduction and other potentially beneficial provisions.

The articles that follow in this special edition of *TAXING TIMES* discuss the specific provisions of the Discussion Draft in detail, but, as an introduction, we would like to provide a framework for thinking about the proposals. First of all, in considering the individual merits of the various proposals, it is important to keep in mind the way insurance companies earn income, because it differs in key ways from most other corporate taxpayers. Insurers collect premiums from policyholders upfront and pay obligations under insurance contracts and related expenses over an extended period. Insurers invest the premiums collected in a way to match the investment earnings to the obligations to policyholders. In light of this business model, it is essential that insurance companies obtain reserve deductions for their expenses before the tax accrual standard is satisfied. Reserve accounting is not a special tax benefit for the industry; it is necessary to clearly reflect income under the insurance industry's unique business model in which a statutory accounting regime requires premiums and investment income to be included in gross income long before claim payments are made.

Consequently, sound tax policy for taxation of life insurance companies should: (1) provide reserve accounting for policy-related expenses; (2) provide consistent character (i.e., capital vs. ordinary) of related items of income and expense; (3) avoid inappropriate multiple taxation of corporate earnings before they are distributed to shareholders; and (4) allow life insurers the same general tax treatment (use of losses, consolidation, etc.) as other corporate taxpayers. Evaluated against these tax policy goals, several of the proposals in the Discussion Draft may have the effect of moving the U.S. tax system away from a proper determination of taxable income of insurance companies. Moreover, the Discussion Draft does not address and remedy a number of current law provisions that are inconsistent with these tax policy goals.

DISCUSSION DRAFT TRADE-OFFS

The most significant benefits for corporations in the Discussion Draft are a proposed reduction in the top marginal corporate tax rate to 25 percent from 35 percent in two- percent increments beginning in 2015,[8] and a repeal of the corporate alternative minimum tax (AMT).[9] In exchange for these benefits, the Discussion Draft proposes a number of changes that would broaden the tax base, including several that would adversely impact insurance companies. Subtitle F of Title III of the Discussion Draft is titled "insurance tax reforms" and includes 15 separate provisions.[10] Other parts of the Discussion Draft include provisions that, while not specifically directed at insurance companies, would have a significant, and probably disproportionately adverse, impact on the industry as compared to most other types of businesses. Provisions in the Discussion Draft generally would be effective for taxable years beginning after Dec. 31, 2014, but it is doubtful this effective date will be retained.

PROPOSALS AFFECTING INCOME

Multiple Taxation of Corporate Earnings: Dividends. A long-standing tax policy is that corporate income should not be subject to multiple layers of corporate income tax. Corporations regularly invest in the stock of other corporations in the ordinary course of business and receive dividends on the stock. The Internal Revenue Code mitigates the effect of multiple levels of corporate tax through a dividends-received deduction (DRD) generally available to all corporations. If the dividend recipient owns at least 80 percent of the stock of the dividend-paying company, the DRD is equal to 100 percent of the amount of the dividend.[11] If the dividend recipient owns at least 20 percent, but less than 80 percent, of the dividend-paying company, the dividend recipient is entitled to an 80-percent DRD.[12] In most other cases involving less than 20 percent ownership, the DRD is limited to 70 percent of the amount of the dividend.[13]

Under current law, life insurers, unlike other corporations, are subject to a special limitation on the DRD commonly referred to as "proration."[14] The tax policy underlying proration is that to the extent dividend income is used to fund policyholder benefits, the life insurer should not be entitled to a double tax benefit—the reserve deduction for the benefits funded by the dividends and, in addition, the DRD.

The Discussion Draft would change the current law proration formula to compute the allowable company's share for both the company's general account and each separate account as a percentage determined by (1) the excess of the mean of the assets over the mean of reserves, divided by (2) the mean of the assets.[15] The practical effect of this formula would be to virtually eliminate the DRD for many insurance companies, even including the DRD related to the portion of dividends that is retained by the company as profit and not credited to policyholders. No noninsurance corporations are treated this way in the Discussion Draft.

Tax-Exempt Interest. Because current-law proration rules applicable to the DRD also apply to tax-exempt interest, most life insurers find that they can achieve a better after-tax yield by investing in taxable bonds. However, some statutory life

CONTINUED ON **PAGE 4**

insurers are nonlife insurance companies for tax purposes because, for example, they may issue large amounts of cancellable group accident and health insurance contracts that do not give rise to life insurance reserves under the 50-percent reserve ratio test for life company status in I.R.C. § 816. Under current law, the level of nonlife insurance companies' investment in tax-exempt bonds is significant because proration for these types of companies currently is a fixed 15-percent reduction in the tax benefit for tax-preferred income items.[16] The Discussion Draft would change this rule to a disallowance of the benefit from preferred income items based on a percentage that is equal to the ratio of the basis of the company's assets producing the tax-preferred income to the basis of all assets of the company.[17] The proposed disallowance formula is complicated and lacks a discernible tax policy objective other than to prevent insurance companies from investing heavily in tax-exempt bonds. For this reason, adoption of the proposal likely would disrupt the tax-exempt bond market and the overall economy in unpredictable ways. Many constituencies are likely to oppose its adoption.

Hedging. Unlike the DRD and tax-exempt interest proposals, the Discussion Draft would improve current law for insurers' hedging transactions. A non-industry-specific proposal in the Discussion Draft would require that derivatives be marked-to-market at the end of each tax year, with any resulting gains or losses treated as ordinary income or loss.[18] The proposal would not apply to transactions properly identified as qualified hedging transactions for tax purposes, and the definition of a hedging transaction would be modified to allow a hedge of a bond or other evidence of indebtedness held by an insurance company to qualify.[19] Under current law, tax hedge qualification does not apply to a hedge of capital assets. Therefore, the proposed change would be a significant benefit, particularly for so-called "gap hedges" (which close a duration gap between capital assets and ordinary liabilities) in light of the Internal Revenue Service's (IRS') questionable current position that gap hedges qualify for tax hedge treatment only if they are more closely related to the liabilities.[20] Adoption of this proposal would resolve many current disputes and, in effect, clarify that tax hedge accounting applies to virtually all insurance company hedges. This treatment would also avoid the inappropriate application of the straddle rules that could occur under the IRS' current position. Although this hedging proposal would be beneficial, the Discussion Draft stopped short of solving all the problems with insurer hedges because it would preserve the character mismatch between the ordinary derivatives and the hedged capital assets.

Other Financial Products Changes. Another major proposal of the Discussion Draft is to require the current accrual of market discount on bonds.[21] As applied to the insurance industry, the revenue estimate of $0.9 billion would appear to be grossly understated.[22] Another sleeper proposal is an expansion of the wash sale rules to apply to related-party sales.[23] The Discussion Draft appears to permanently disallow a loss on sales between affiliated corporations in the same ownership chain because there is no provision for a carryover of basis. This harsh treatment probably is unintended and would need to be fixed. Otherwise, for example, parent-subsidiary conventional coinsurance transactions where depreciated assets are transferred could not occur without a tax cost.

Other Income. The Discussion Draft includes a sweeping proposal that would generally require taxpayers that use the accrual method of accounting to include an item in taxable income no later than the year in which the item is included in income for financial statement purposes.[24] As written, this rule is extremely broad and would apply in a wide range of situations that probably were not contemplated. For example, the proposed rule appears to cover embedded derivatives that are required to be marked-to-market for financial accounting purposes, even though the Discussion Draft's separate proposal requiring that derivatives be marked-to-market excepts certain embedded derivatives from its scope.[25] This proposal needs further consideration to avoid unintended consequences.

So far, based on the provisions affecting the income side of life insurance companies, how would the life insurance industry fare under the Discussion Draft? It seems to these authors that the adverse impact on the DRD, tax-exempt interest, and accrual of market discount far outweigh the favorable tax reform with respect to hedging transactions.

PROPOSALS AFFECTING DEDUCTIONS

The major changes in the Discussion Draft relating to deductions involve insurance reserves and policy acquisition costs.

Tax Reserves. The Discussion Draft would replace the current-law prescribed discount rate for life insurance reserves[26] with the average applicable federal mid-term rate over the 60 months ending before the beginning of the calendar year for which the determination is made, plus 3.5 percentage points.[27] For unpaid losses on contracts other than life insurance contracts, the discount rate would be changed to the corporate bond yield curve (as specified by Treasury).[28] The rationale for these proposed changes is that the discount rate on tax reserves should better match the rate of return on corporate bonds held to fund the reserve liabilities. However, the proposals undoubtedly would result in excessive discounting and inadequate reserve deductions under many economic conditions.

With respect to life insurance reserves, the discounting proposal also seems to miss an opportunity for real tax reform. The trend in statutory reserves is to move from deterministic net premium reserves to principle-based stochastic reserves with unlocked assumptions. The Discussion Draft would impose a discounting rule that assumes the continued use of traditional reserving methods and does not adequately address how the tax law should apply to evolving reserve methodologies.

The Discussion Draft would repeal I.R.C. § 807(f), which provides a 10-year spread of adjustments resulting from most changes in assumptions in computing tax reserves by life insurance companies.[29] Under the Discussion Draft, a change in computing reserves would not require IRS consent, but the other general rules for tax accounting method changes would apply.

The Discussion Draft fails to address the inconsistent tax treatment of life and nonlife insurance companies under current law. For example, statutory accounting rules require both types of insurance companies to report loss adjustment expenses (LAE) on an estimated basis. Even though the same tax reserve discounting rules also apply for unpaid losses of both types of companies,[30] the IRS' position is that only nonlife insurance companies are permitted a tax deduction for estimated unpaid LAE. A comprehensive tax reform package should fix this inconsistency and permit all insurers to deduct LAE, along with the unpaid losses to which they relate, on an estimated discounted basis.

The Discussion Draft would make a little-noticed conforming change that could have a major impact on disability income disabled-lives reserves. The proposal would eliminate the special rule in I.R.C. § 846(f)(6)(A) that permits the reserve discount rate to be determined at the time the disability claim is incurred, rather than the time the contract was originally issued, at least for cancellable contracts.[31] A more logical rule would conform the tax treatment to the statutory accounting requirements and use the claim-incurral date to determine the discount rate. Moreover, in overall tax reform this rule probably should apply for all disability income claim reserves, including reserves that qualify as life insurance reserves.

DAC. The Discussion Draft would modify the policy acquisition expense capitalization rules (the so-called "DAC tax")[32] that require a percentage of net premiums to be capitalized and amortized over 10 years. Under current law, the net premium percentages required to be capitalized are 1.75 percent for nonqualified annuities, 2.05 percent for group life insurance, and 7.7 percent for certain other types of insurance. The Discussion Draft would increase these percentages and use only two categories—5 percent for group insurance contracts and 12 percent for all other specified contracts.[33] This proposal seems particularly harsh for annuity contracts, which rarely have acquisition costs as high as 12 percent. When the increase in the DAC tax is coupled with the potential impact of the DRD proposal, the impact on variable annuities likely would be a significant increase in charges to the customer even taking into account the lower 25-percent corporate tax rate. This higher cost will be greater for the years immediately following enactment of the DAC tax increase because the lower corporate tax rate is phased in but the higher DAC tax rates are not.

Another problem with the DAC proposal is that it seems to duplicate another provision in the Discussion Draft. Under Draft Tax Reform Act of 2014, § 3110, only 50 percent of advertising expenses would be permitted as a deduction, with the remaining 50 percent amortized over a 10-year period. Because the DAC capitalization amounts presumably are intended to encompass all policy acquisition costs, including advertising expenses, this proposed 50-percent of advertising expense disallowance probably should not be made applicable to life insurance companies.

Other Deduction Items. The Discussion Draft has many other miscellaneous changes to deductions, but four have particular relevance to insurers. One proposal would deny a domestic insurance company a deduction for property and casualty reinsurance premiums paid to a related company that is not subject to U.S. taxation on the premiums (or foreign taxation at an equal or greater rate of tax), unless the related company elects to treat the premium income as effectively connected to a U.S. trade or business (and thus subject to U.S. tax).[34] This proposal is essentially the same as the so-called "Neal Bill," which is intended to deny a tax advantage to U.S. insurers with foreign parents located in low-tax jurisdictions.[35]

CONTINUED ON **PAGE 6**

A second proposal would repeal the I.R.C. § 806 small life insurance company deduction. [36]

A third proposal would revise and extend the provisions in I.R.C. § 265 that disallow interest deductions for companies that invest in tax-exempt bonds.[37] This provision would be in addition to the proration changes and, obviously, would affect insurers that are taxed as nonlife insurance companies and invest in tax-exempt bonds (assuming that tax-exempt investments remain viable in light of the proposed proration changes).

No tax reform effort should eliminate tax provisions that are needed to avoid over-taxation of corporate earnings.

A fourth, non-industry-specific, provision would require that research and development expenses be amortized over a five-year period instead of being currently deducted.[38]

To summarize the deduction proposals, it seems to be all bad news. The increase to the DAC tax percentages and reserve discounting rates appears to be too high, and in the case of advertising expenses, duplicative. And, an opportunity for real tax reform has been missed by not accommodating modern reserving methods, not fixing current law problems, and creating, perhaps inadvertently, reserve problems that do not currently exist (disabled-lives reserves).

OTHER PROPOSALS AFFECTING TAX LIABILITY

Use of Losses. The Discussion Draft appears to want to conform the tax treatment of life insurers' losses from operations to the treatment of net operating losses (NOLs) of other types of corporations. But it does not succeed. The Discussion Draft would change the current three-year carryback and 15-year carryforward rule for operations losses applicable to life insurance companies[39] to a two-year carryback and 20-year carryforward rule.[40] This proposal would result in NOL conformity with other taxpayers, but the Discussion Draft does not address the life/nonlife consolidated return rules that require life and nonlife subgroup losses to be computed separately and prevent one subgroup's losses from fully offsetting the other subgroup's income.[41] In addition, although the Discussion Draft would repeal the corporate AMT, it would effectively reinstate and expand a key AMT provision by allowing a corporation's NOL carryover or carryback to offset no more than 90 percent of the corporation's taxable income (determined without regard to the NOL carryover or carryback). [42]

Another adverse aspect of the Discussion Draft is what it does not do for capital losses, but should have done, as part of tax reform. Under current law, capital losses can only offset capital gains. Although unused capital losses can be carried forward, they expire if they are not used in five years. As Camp was developing his proposals, members of the insurance industry urged him to address the fundamental problem insurers face with the limitation on capital losses on sales of investment assets used to fund ordinary liabilities. In rising interest rate environments, substantial capital losses from asset sales could be generated and expire unused after five years. To prevent this inappropriate result, comprehensive tax reform should designate insurance company investment assets to have an ordinary character to match the character of the insurance obligations they fund.

Foreign Income. The Discussion Draft proposes to adopt a territorial tax regime to make the United States competitive with other countries.[43] It would accomplish this result by introducing a participation exemption system for the taxation of foreign business income. The participation exemption would take the form of a 95-percent DRD for the foreign-source portion of dividends received from controlled foreign corporations (CFCs) by domestic corporations that are 10 percent shareholders of those CFCs. No foreign tax credit (or deduction) would be allowed for any foreign taxes paid or accrued with respect to any exempt dividend.

A transition rule would require a 10-percent U.S. shareholder of a CFC to include in income its pro rata share of the CFC's previously deferred foreign income, which would be taxed at a rate of 8.75 percent in the case of the CFC's earnings and profits (E&P) retained in the form of cash and cash equivalents and 3.5 percent in the case of all other E&P. Foreign tax credits would be partially available to offset this tax and an election would be available to pay the resulting U.S. tax liability in installments over a period of up to eight years.

There are many other detailed rules that would substantially revise the regime for taxing foreign-source income. One item of special interest to insurers is the active financing exception, which has been a feature of the tax law for the last 15 years (albeit as a repeatedly extended temporary provision).[44] The

Discussion Draft would extend the provision for five more years so that insurers and other financial institutions could benefit from the territorial regime in the same manner as other industries.[45] Unlike other industries, however, the continued temporary nature of the active financing exception would leave insurers facing considerable uncertainty over the taxation of the earnings from their foreign insurance operations after that time, with the possibility that insurers would face much higher U.S. taxation on their foreign earnings than other industries. Moreover, insurance companies would be fully subject to the transition rule requirement to include all previously deferred income of their CFCs in income even though they might not receive the benefits of the participation exemption after the temporary five-year extension of the active financing exception expires.

Bank Tax. The Discussion Draft also would impose a quarterly excise tax on every systemically important financial institution as defined in the Dodd-Frank Wall Street Reform and Consumer Protection Act (i.e., certain domestic banks and insurance companies).[46] The tax would be 0.035 percent on assets in excess of $500 billion, with this threshold indexed for increases in the gross domestic product beginning in 2016. Although this provision would affect only a handful of companies, it seems particularly unfair to impose on assets of state-regulated insurers if the tax policy is to reimburse the federal government for the increased regulatory oversight of large financial companies.

Transition Rules. A significant factor in evaluating the impact of the Discussion Draft is its various transition rules. To achieve revenue neutrality with the reduced corporate rate, several transition rules appear to be unduly harsh with the primary goal to raise revenue during the 10-year estimating window. For example, a fresh start is not granted for the change to nonlife reserve discounting, but instead, an I.R.C. § 481-type adjustment would be spread over eight years.[47] In addition, the reduced corporate tax rate of 25 percent would be phased in.[48] And, as discussed above, insurers would be required to include in income all previously deferred foreign income of their CFCs even though the new participation exemption regime generally would not benefit them beyond the five-year period covered by the temporary extension of the active financing exception. [49]

These miscellaneous aspects of the Discussion Draft may best be evaluated by summarizing what could have been proposed in the interest of comprehensive tax reform and simplification, but is not included in the Discussion Draft. It is unfortunate that the Discussion Draft does not fix the current-law problems of capital asset/ordinary liability character mismatch and outdated life/nonlife consolidated return limitations, and make the active financing exception permanent.

POLICYHOLDER CONSIDERATIONS

The Discussion Draft includes provisions targeted at individuals that might reduce the incentive for them to save for retirement.[50] Moreover, it would directly discourage insurance protection by expanding the pro rata interest expense disallowance rule for corporate-owned life insurance. The exception for contracts covering a single employee, officer and director would be eliminated (i.e., only insurance on 20-percent owners would be excepted).[51]

Significantly, the Discussion Draft does not propose to change the taxation of the inside buildup of life insurance contracts. The industry has long opposed changes to the taxation of inside buildup because of the adverse impact any such changes would have on policyholders and beneficiaries, and the Discussion Draft appears to have heeded the industry's concerns. However, the other changes proposed by the Discussion Draft, including those that seek to raise additional revenue from insurance companies, likely would lead to an increase in the cost to consumers of various retirement savings products and insurance protection offered by insurers and a decrease in consumption of these items that benefit society. The lack of transition rules for certain proposals, such as the DAC tax increase, would have an adverse impact on previously issued contracts that have been priced based on existing tax law. Presumably, the rationale for not providing retroactive protection of the economics of existing contracts is that Camp assumed that the reduced 25-percent tax rate would offset the increased taxable income to the company, but this, in fact, probably is an incorrect assumption for several product lines.

OTHER CONSIDERATIONS

A few of the Discussion Draft's proposals have previously been discussed as possible changes to the tax laws, and thus have been the subject of public discussion and analysis for some time. For example, the Administration's budget proposal has, for several years, included proposals to disallow a life insurance company's separate account DRD in the same

CONTINUED ON **PAGE 8**

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proportion that the mean of the separate account reserves bears to the mean of the separate account assets,[52] to repeal the exception from the pro rata interest expense disallowance rule for corporate-owned life insurance contracts covering employees, officers or directors, other than 20-percent owners of the business that is the owner or beneficiary of the contracts,[53] and to disallow deductions for certain foreign related-party property and casualty reinsurance premiums.[54] The inclusion of these proposals in the Discussion Draft likely did not come as a surprise to the industry, although certain modifications to the proposals raise new issues. In addition, the Discussion Draft appears to have listened to the industry's previously expressed concerns about the consequences to policyholders and beneficiaries of attempting to tax the inside buildup of life insurance contracts and did not include any such proposal. In other respects, however, the scope of the proposals in the Discussion Draft specifically addressed to the insurance industry (as well as the broader changes that would impact the industry) caught many in the industry by surprise.

Few people believe tax reform will be enacted this year. While Camp has been an active participant in the tax reform process, he announced on March 31, 2014, that he will not seek re-election.[55] Assuming the Republicans maintain a majority in the House in this fall's election, Reps. Paul Ryan (R-WI) and Kevin Brady (R-TX) are generally viewed as the leading contenders to replace Camp as Ways and Means Committee chairman in the next Congress. Both Ryan and Brady are tax reform proponents and would undoubtedly bring their own tax reform ideas to the position. However, neither individual is likely to ignore the Discussion Draft and all of the work that has gone into it. Rather, both Ryan and Brady can be expected to consider each of the proposals in the Discussion Draft in developing their own tax reform proposal, with the result that some proposals might be included unchanged; others might be abandoned; and still others might be incorporated in a modified form.

In the Senate, the tax reform process is somewhat behind the House. In part, the delay is due to the fact that Senate Finance Committee Chairman Ron Wyden (D-OR) has only held the position since Feb. 12, 2014. Wyden replaced Sen. Max Baucus (D-MT), who resigned from the Senate to become the U.S. Ambassador to China. Shortly before his departure, Baucus released discussion drafts on international business tax reform, tax administration reform, cost recovery and tax accounting reform, and energy tax reform, but not a comprehensive discussion draft. Wyden previously co-authored two bipartisan tax reform bills, first with Sen. Judd Gregg (R-NH) in 2010[56] and then with Sen. Dan Coats (R-IN) in 2011.[57] Wyden has indicated he intends to explore whether the ideas in those bills can serve as a basis for the Finance Committee's tax reform effort. He also has indicated he will hold hearings on tax reform. But he too can be expected to consider each of the proposals in the Discussion Draft.

CONCLUSION

The proposals in the Discussion Draft are likely to be a continuing part of the tax reform discussion. That is not to suggest, however, that any particular proposal will be enacted or will not be modified before enactment. Camp released the Discussion Draft to generate discussion and to provide a context for that discussion. As many of the proposals in the Discussion Draft (including most of the insurance tax reforms) are being considered publicly for the first time, it is important that the insurance industry provide input to Congress, including on issues such as whether implementation of a given proposal might present technical or administrative difficulties, the impact a proposal might have on the pricing or availability of certain insurance products, and whether a proposal might be based on a misunderstanding of how the industry operates. The insurance industry should also use this opportunity to alert Congress to additional areas in which current law can be improved to further the goals of tax reform.

END NOTES

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6 Joint Committee on Taxation, *Macroeconomic Analysis of the "Tax Reform Act of 2014"* (JCX-22-14) (Feb. 26, 2014); Press Release, House Committee on Ways and Means, *supra*.
7 Joint Committee on Taxation, *Distributional Effects of the "Tax Reform Act of 2014"* (JCX-21-14) (Feb. 26, 2014).
8 Draft Tax Reform Act of 2014, § 3001.
9 *Id.* § 2001.
10 *Id.* §§ 3501-3515.
11 I.R.C. § 243(a)(3). Unless otherwise indicated, all I.R.C. § references and references to "the Code" in this *TAXING TIMES* supplement are to the Internal Revenue Code of 1986, as amended.
12 I.R.C. § 243(c).
13 I.R.C. § 243(a)(1).
14 I.R.C. § 812.
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17 Draft Tax Reform Act of 2014, § 3508.
18 *Id.* § 3401.
19 *Id.* § 3402(a)(1).
20 T.D. 8555 (preamble), 1994-2 C.B. 180.
21 Draft Tax Reform Act of 2014, § 3411.
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24 *Id.* § 3303.
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34 *Id.* § 4212.
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36 Draft Tax Reform Act of 2014, § 3503.
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41 I.R.C. §§ 1503(c)(1), 1504(c).
42 Draft Tax Reform Act of 2014, § 3106.
43 *Id.* §§ 4001-4212.
44 The active financing exception was first adopted in 1997 to be effective for the 1998 taxable year. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1175. It was subsequently modified and extended on multiple occasions so that it was in effect through 2013. Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, § 1005; Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 503; Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 614; Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 103(a); Tax Extenders and the Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, § 303; Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 750; American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 322.
45 Draft Tax Reform Act of 2014, § 4204.
46 *Id.* § 7004.
47 *Id.* § 3510(e).
48 *Id.* § 3001(a).
49 *Id.* §§ 4003, 4204.
50 *See, e.g., id.* §§ 1601-1624, 3801.
51 *Id.* § 3501.
52 *E.g.,* Department of the Treasury, General Explanation of the Administration's Fiscal Year 2014 Revenue Proposals 65 (Apr. 2013).
53 *E.g., id.* at 67.
54 *E.g., id.* at 52.
55 Under House Republican rules, Camp would have had to surrender the chairmanship of the Ways and Means Committee at the end of the year, which may have contributed to his decision to retire.
56 S. 3018, 111th Cong. (2010).
57 S. 727, 112th Cong. (2011).

SECTIONS 3506 AND 3508: INSURANCE COMPANY PRORATION

By Robert Shanahan and Mark Smith

Draft Tax Reform Act of 2014, § 3506 would change the rules for prorating a life insurance company's investment income between the "company's share" and "policyholders' share" to dramatically reduce the dividends-received deduction (DRD) that a life insurer may claim with regard to otherwise-eligible dividends received. Draft Tax Reform Act of 2014, § 3508 would likewise change the proration regime and in doing so increase the tax burden for nonlife insurance companies.

A SHORT-LIVED CONTROVERSY UNDER CURRENT LAW

Under current law, a corporate taxpayer is generally permitted a DRD with regard to dividends received from other domestic corporations, in order to limit the taxation of two different corporations on the same income. In the case of a life insurance company, however, a DRD is allowed only with regard to the "company's share" of eligible dividends received. Similarly, a life insurer's otherwise-deductible life insurance reserves are reduced by the amount of the policyholders' share of tax-exempt interest. The presumed purpose of these rules is to prevent the double benefit a company otherwise would enjoy if tax-deductible reserves were funded by tax-preferred income.

In the early 2000s, the IRS addressed separate account proration issues in technical advice memoranda (TAMs) that generally confirmed the industry's approach to company's share and policyholders' share of net investment income.[1] The analysis of those TAMs generally determines required interest (and hence, ultimately, the company's share) by applying section 1.801-8(e) of the regulations, which was promulgated under the 1959 Act.[2] This approach was based on Congress' instruction that, where provisions carried over from the 1959 Act, the 1959 Act authorities are to be used as interpretive guides.

In Rev. Rul. 2007-54,[3] the IRS took a contrary approach, concluding that required interest must be determined using the greater of the Applicable Federal Interest Rate or the Prevailing State Assumed Interest Rate.[4] That position was short-lived, however, as Rev. Rul. 2007-54 was promptly suspended by Rev. Rul. 2007-61[5] so that the IRS and Treasury could give the issue more thought and publish further guidance. In 2010, the IRS Industry Director for Financial Services published an Industry Director's Directive (IDD) instructing that, pending guidance in the form of regulations, revenue agents are not to challenge taxpayers who applied the life insurance proration rules in a manner consistent with the earlier TAMs.[6]

Most of the controversy over life insurance company proration under current law has hopefully been resolved. In Rev. Rul. 2014-7,[7] the IRS "modified and superseded" Rev. Rul. 2007-54 by republishing the part of Rev. Rul. 2007-54 that did not concern proration. The IRS and Treasury have indicated informally that this action was intended to effectively revocate the proration conclusion in the 2007 ruling. In addition, the IDD remains in effect, instructing revenue agents to "consider raising" the issue if a life insurance company uses a methodology that is inconsistent with I.R.C. § 812 or Reg. § 1.801-8(e) as illustrated by the prior TAMs. Also, the Administration's most recent revenue proposals include a proposal to change the current-law rules for proration (implying that a change in this area is more appropriately considered, if at all, prospectively and by legislation).

A SMALLER DEDUCTION UNDER THE DISCUSSION DRAFT

The Discussion Draft would dramatically reduce the company share. Under the Discussion Draft, the company's share would equal the mean assets of the account less the mean reserves of the account, divided by the mean assets in the account. In other words, company's share percentage would equal (mean assets – mean reserves) / mean assets. The policyholders' share would equal 100 percent less the company's share.

The Ways and Means staff explanation of the provision is that it would provide an "updated" computation of company's and policyholders' share of net investment income that is "simpler and more accurate." Whether this is in fact the case will no doubt be the subject of debate. Although the existing regime has been criticized as complex, an approach that requires the computation of mean assets and mean reserves, account by account, could pose interpretive challenges in application. It also would be more complex than proration based on a flat percentage of tax-preferred income, or no proration at all. Most importantly, it is unclear in what sense the proposed approach would be more "accurate." Other industries are permitted to use dividend income to fund business expenses without a reduction of the DRD. In this sense, the proposal continues a rule that singles out the life insurance industry and that departs from the purpose of the DRD, which is to prevent the same business income from being taxed to two different corporations.

For each of the past fiscal years since 2009, the Obama Administration revenue proposals have included proposals to change the rules for life insurance company proration. Those proposals have evolved somewhat over time. For a company's general account, the Fiscal Year 2015 Obama Administration proposal would provide one rule for a company's general account and a different rule for the separate accounts. For the general account, the company's tax-preferred income (DRD, tax-exempt interest and inside buildup) would be subject to a fixed 15 percent proration disallowance, similar to the present law rule for a nonlife insurance company.[8] The Administration's proposal for the general account is thus significantly more favorable (and less complex) than the approach in the Discussion Draft. For a company's separate accounts, "the limitations on DRD that apply to other corporate taxpayers would be expanded to apply explicitly to life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of the account."[9] Mechanically, this differs from the Discussion Draft, which would retain the concept of proration but provide a different formula for calculating the company's share and policyholders' share. As a practical matter, however, both approaches could be expected to disallow similar amounts of DRD with regard to a separate account.

The Joint Committee on Taxation estimates that Draft Tax Reform Act of 2014, § 3506 would generate approximately $4.5 billion from 2014 to 2023.[10] In contrast, the Administration estimates that its own proposal would generate approximately $6.3 billion from 2015 to 2024.[11]

A PRORATION CHANGE FOR NONLIFE INSURANCE COMPANIES AS WELL

In addition to changing the proration rules for life insurance companies, the discussion draft would change the proration rules for nonlife companies. Under current law, the amount that a nonlife insurance company otherwise may deduct as losses incurred is reduced by an amount equal to 15 percent of the sum of the tax-exempt interest received, the aggregate amount of DRD the company might have claimed, and the increase in policy cash values. The limitation is important, as property and casualty insurers are significant investors in tax-exempt bonds. The rationale for the limitation is the same as that presumed for life insurance company proration, to limit the benefit that otherwise would result from funding tax-deductible losses incurred with tax-preferred income. The operation of the 15 percent reduction under current law is straightforward, such that nonlife proration, unlike life proration, has not historically been an area of controversy between the IRS and nonlife insurance companies.

Draft Tax Reform Act of 2014, § 3508 would change the proration regime for nonlife companies and, in doing so, significantly increase the amount by which deductible losses incurred must be reduced. Under this section, the present-law 15 percent reduction would be replaced by a reduction percentage equal to the ratio of the average adjusted bases of tax-exempt assets to the average adjusted bases, with adjustments, of all assets of the company. The ratio would thus differ from the ratio set forth in Draft Tax Reform Act of 2014, § 3506 for life insurance companies, which is based on the relationship between reserves and total assets. The Ways and Means staff explanation of the provision says that the provision would replace an "arbitrary" fixed percentage reduction with a formula that "more accurately" measures the reserve deduction. Whether the provision "more accurately" measures reserve deductions will likely be a matter of debate for many of the same reasons that apply to life insurance company proration. The most accurate reflection of the amount an insurer owes its policyholders has nothing to do with the sources of the insurer's income, and the provision[12] would add significant complexity to the taxation of nonlife insurance companies. In addition, Draft Tax Reform Act of 2014, § 3508 appears to overlap another provision in the discussion draft that would extend a current-law interest disallowance based on the same tax-preferred income, potentially subjecting a nonlife compa-

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ny to a double disallowance with respect to the same amounts. This overlap appears not to have been intended.

The proposal would be effective for taxable years beginning after Dec. 31, 2014.[13] The provision is estimated to generate approximately $2.9 billion from 2014 to 2023.[14]

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END NOTES

1 *See, e.g.,* TAM 200038008 (June 13, 2000), TAM 200339049 (Aug. 20, 2002).
2 Under the 1959 Act, I.R.C. § 809 excluded the policyholders' share of each and every item of investment yield from the company's gain or loss from operations, allowing the company to deduct company's share of tax-exempt interest and DRD with regard to the company's share of eligible dividends. Like present-law I.R.C. § 817(c), I.R.C. § 801(g) required separate accounting with regard to contracts with reserves based on a segregated asset account. Section 1.801-8(e) of the regulations explains how the separate accounting requirement of I.R.C. § 801(g) applied to compute the company's share and policyholders' share of net investment income with regard to a segregated asset account.
3 2007-38 I.R.B. 604, *modified and superseded* by Rev. Rul. 2014-7, 2014-9 I.R.B. 539.
4 For additional background on the issue, see "Proration for Segregated Asset Accounts—How is the Company's Share Computed?" Susan Hotine, Taxing Times, September 2007; "Proration for Segregated Asset Accounts—Part Two," Susan Hotine, *Taxing Times*, February 2008.
5 2007-42 I.R.B. 799, *obsoleted by* Rev. Rul. 2014-7, 2014-9 I.R.B. 539.
6 "Examination of Dividends Received Deduction on Separate Accounts of Life Insurance Companies," LMSB Control No.: LMSB-4-0510-015 (May 20, 2010).
7 2014-9 I.R.B. 539.
8 That rule is found in I.R.C. § 832(b)(5)(B).
9 *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* (March 2014), page 72.
10 Joint Committee on Taxation, *Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14) (Feb. 26, 2014), page 8.
11 *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* at page 281.
12 Draft Tax Reform Act of 2014, § 3124.
13 The JCT summary states that a transitional rule would ratably allocate the adjustment resulting from Draft Tax Reform Act of 2014, § 3508 over eight years for any tax year impacted after Dec. 31, 2014. Joint Committee on Taxation, *Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14) (Feb. 26, 2014), page 196. Although Draft Tax Reform Act of 2014, § 3508 itself makes no mention of such a transitional rule, Draft Tax Reform Act of 2014, § 3510(e) provides an eight-year spread for adjustments resulting from other changes to I.R.C. § 832(b)(5), and likely would apply to adjustments resulting from the nonlife proration change as well.
14 Joint Committee on Taxation, *Estimated Revenue Effects of the "Tax Reform Act of 2014,"* page 8.

SECTIONS 3401 TO 3434: TAXATION OF FINANCIAL PRODUCTS

By Brion D. Graber and Peter H. Winslow

In January 2013, Chairman Camp released a discussion draft proposing changes to the tax treatment of financial products and invited comments on the draft.[1] The financial products proposal potentially having the greatest impact on life insurance companies related to the tax treatment of derivatives and required that they be marked to market. The comprehensive Tax Reform Discussion Draft released by Camp on Feb. 26, 2014 incorporated the earlier derivatives proposal, but with a key modification to address concerns raised by the insurance industry in response to the January 2013 draft. Before getting into these and other proposed changes to the taxation of financial products included in the comprehensive Tax Reform Discussion Draft, however, a little background on current tax law as it applies to life insurance company hedges is appropriate.

CURRENT LAW

An insurance company's investments are classified as capital assets for tax purposes, despite the fact that they generate ordinary income while held and are used to support obligations that generate deductions from ordinary income. The capital treatment of these investment assets creates significant timing and character mismatches for insurance companies, which are made worse by current law's failure to permit tax hedge qualification for insurers' business hedges of capital assets and the IRS' position that not all insurers' hedges can be classified as primarily managing risks with respect to ordinary liabilities.

Hedging Transactions. Qualification for tax hedge accounting is beneficial for several reasons. The taxpayer is entitled to adopt an accounting method that clearly reflects income through matching of the timing of income, deductions, gains and losses, in the hedging transaction and the item(s) hedged.[2] Gains and losses have ordinary character permitting a character match to ordinary liabilities.[3] In addition, tax hedges are excepted from the adverse effects of the straddle and I.R.C. § 1256 mark-to-market rules.[4]

To qualify for tax hedge treatment, a hedging transaction must (1) manage risk of price changes or currency fluctuations with respect to ordinary property, or (2) manage risk of interest rate, price changes or currency fluctuations with respect to ordinary obligations (policy liabilities).[5] Significantly, a transaction that hedges a risk relating only to a capital asset (such as an insurance company's investment assets) does not qualify for tax hedge treatment. Duration gap hedges (which relate to both capital assets and ordinary liabilities) are particularly problematic under current law because the IRS takes the position that tax hedge qualification applies only if the hedge is more closely related to ordinary liabilities than to capital assets.[6] This standard is difficult to apply because, by definition, a gap hedge relates to both assets and liabilities and closes the duration gap between the two.

A failure to qualify for tax hedge treatment can result in a character mismatch of capital losses on the hedging instrument even though any economic gain from the insurance products is ordinary. There also can be a timing mismatch because the gain or loss on the derivative is not matched to the tax recognition of the hedged item—the capital asset, the policy obligations, or both.

Straddle Rules. These mismatches can be made worse if the straddle rules apply. Straddles are offsetting positions that substantially reduce the risk of loss on interests in personal property of a type that are generally actively traded.[7] Under the general straddle rules, loss deductions are deferred to the extent of unrecognized gains in any offsetting position.[8] If the loss relates to a position in an identified straddle (i.e., any straddle that is clearly identified as such on the taxpayer's books and records before the close of the day on which the straddle is acquired), the loss is disallowed and instead the basis of each of the identified positions offsetting the loss position in the identified straddle is increased by a specified percentage of the loss.[9] These straddle rules are problematic when an insurer enters into a hedging short position that the IRS considers an offset to

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capital assets. Losses on sales of the derivative could be deferred, sometimes indefinitely in the case of a macro hedge of an entire asset portfolio.

Mark-to-Market Requirements. Failure to qualify as a tax hedge can be made even worse if current law's mark-to-market rules apply. The tax law provides that each I.R.C. §1256 contract held by a taxpayer at the end of the tax year be treated as though it were sold for its fair market value on the last business day of the year, with any resulting gain or loss taken into account.[10] Sixty percent of any gain or loss is treated as long term and the remaining 40 percent is treated as short term.[11] When the taxpayer ultimately disposes of the I.R.C. § 1256 contract, any gain or loss previously included in income as the result of marking to market must be taken into account in determining the gain or loss of the actual disposition of the asset.[12] An I.R.C. § 1256 contract includes any regulated futures or foreign currency contract, but does not include swaps. Consequently, insurers hedging capital assets with futures under current law can exacerbate the timing mismatches and distort taxable income.

The insurance industry recommended that Camp include in tax reform a provision that would designate bonds and other debt instruments held by insurers as ordinary assets for all tax purposes.

JANUARY 2013 DISCUSSION DRAFT

The January 2013 discussion draft included a proposal that would require mark-to-market and ordinary treatment for all positions in a straddle that includes any derivative to which the proposal applied, even if the positions were not otherwise marked to market (i.e., a mixed straddle).[13] This proposal would have made insurers' hedging problems even worse than under current law because it would have required mark-to-market treatment of the hedged capital assets as well as the derivatives.

To address the concerns with the derivatives proposal, the insurance industry recommended that Camp include in tax reform a provision that would designate bonds and other debt instruments held by insurers as ordinary assets for all tax purposes.[14] This solution to the problems with the derivatives proposal would have the additional benefit of addressing both the timing and character mismatches of current law, and not just the specific problems with insurers' hedges.

FEBRUARY 2014 DISCUSSION DRAFT

Hedging. The comprehensive Tax Reform Discussion Draft includes a proposal similar to the derivatives proposal in the January 2013 discussion draft. Notably, however, it now includes an explicit statement that insurance, annuity and endowment contracts issued by insurance companies are not derivatives requiring mark-to-market treatment, even if the contracts include what could be considered embedded derivatives, such as equity-indexed products. It also includes a new proposal that would expand the definition of a qualified tax hedge to include transactions involving hedges of debt instruments held by insurance companies even though the hedge is of capital assets.[15] This proposal was included in response to the concerns raised by the insurance industry with the January 2013 discussion draft's derivatives proposal.

Allowing an insurer's business asset hedges to qualify as tax hedges would address most income/deduction timing mismatches that occur under existing law and would generally prevent the derivatives proposal from exacerbating those mismatches. However, the hedging proposal could exacerbate capital asset/ordinary liability character mismatches in certain market scenarios because the sale of the underlying hedged bonds would still be treated as the sale of a capital asset. For example, in a rising interest rate environment, the sale of a portion of the bond portfolio likely results in a capital loss. Under current law, the capital loss may be offset in whole or part when the assets are hedged economically with short derivative positions (which give rise to capital gains). Under the 2014 Discussion Draft's hedging proposal, however, the derivatives would yield ordinary income, which the capital losses cannot offset. Instead, the capital losses would be deferred, and perhaps expire at the end of a five-year carryforward period, unless there is another source of capital gains (which is unlikely in a rising interest rate environment). Thus, in this scenario, the ordinary treatment of derivatives as qualified tax hedges without a corresponding ordinary treatment of assets could result in a worse mismatch, and a greater potential for the inability to deduct capital losses, than under current law.

In addition, the Discussion Draft's hedging proposal fails to address the problem of capital asset/ordinary liability character mismatches outside of the hedging context. Any comprehensive tax reform effort should also correct these mismatches. Adopting the insurance industry's suggestion to treat debt instruments held by insurance companies as ordinary assets for all purposes would solve both the character and timing mismatches that exist under current law.

The Discussion Draft also contains some technical issues for insurance companies. For example, the Discussion Draft proposes to expand current law's specific tax hedge identification rules to allow identification of a transaction as a hedging transaction for financial accounting purposes (i.e., within the meaning of generally accepted accounting principles) to constitute adequate identification for tax hedge qualification.[16] While that rule would be a significant simplification to the hedging rules for many companies in other industries, it would be inadequate for insurance companies that are required to follow statutory accounting rules. To allow insurance companies to benefit from the proposed simplification, it should be expanded to allow identifications of hedges made for statutory accounting purposes (as well as those made for financial accounting purposes) to satisfy the identification requirement for tax purposes.

Other Financial Products Changes. The Discussion Draft would require the inclusion in income of accrued market discount in the same manner as original issue discount, but would limit the accrual amount for distressed debt.[17] The Joint Committee on Taxation estimated this proposal would raise \$0.9 billion, which would appear to be grossly understated as applied to the insurance industry.[18] The proposal includes two features intended to minimize the character and timing mismatches that would result from requiring a taxpayer to include market discount in ordinary income on a current basis with the possibility of recognizing a capital loss (as a result of basis increases associated with the income inclusions) in a later year when the bond is sold or otherwise disposed. First, as a rough approximation of market discount attributable to changes in market interest rates rather than doubts about a particular issuer's ability to repay the debt, the proposal would limit the required accrual to an amount determined using a discount rate equal to the greater of (i) an amount equal to the bond's yield to maturity (determined as of the date of the issuance) plus five percentage points or (ii) an amount equal to the applicable federal rate for the bond (determined at the time of acquisition) plus 10 percentage points. Second, the proposal would treat any loss that results on the sale or other disposition of a bond as an ordinary (rather than capital) loss to the extent of previously accrued market discount.

The original issue discount rules, on which the market discount proposal is based, are a set of rules designed to allow taxpayers to approximate for tax purposes the economic interest income from bonds purchased at a discount. However, the tax law already permits life insurance companies to determine their original interest discount inclusions for tax purposes using the same method that they use for statutory accounting purposes.[19] To the extent the market discount proposal is intended to apply to life insurance companies, life insurers should be permitted to use the same method that they use for statutory accounting purposes.

A separate proposal would expand the wash sale rules to apply to related-party sales, which are defined to include transactions between two corporations when one corporation owns (directly or indirectly) more than 50 percent of the other corporation.[20] This proposal does not include a provision for the carryover of basis in related-party wash sales (except when the related party is the taxpayer's spouse) and thus would appear to permanently disallow a loss on sales between affiliated corporations in the same ownership chain. Such a result would be quite harsh and is likely unintended. If this issue with the proposal is not addressed, then, for example, parent-subsidiary conventional coinsurance transactions in which depreciated assets are transferred could not occur without a tax cost because such transactions would be wash sales.

Another proposal would generally require taxpayers using the accrual method of accounting to include an item in taxable income no later than the year in which the item is included in income for financial statement purposes.[21] Similar to the wash sale proposal, this proposal is written in such a way that it likely would have unintended consequences. As one example, the proposed financial ac-

CONTINUED ON **PAGE 16**

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counting/tax income matching rule appears to require that embedded derivatives that are marked-to-market for financial accounting purposes must also be marked-to-market for tax purposes. However, that result conflicts with the apparent policy set forth in the Discussion Draft's separate proposed specific exclusion of insurance products from mark-to-market treatment for embedded derivatives.[22]

The Discussion Draft also includes financial products proposals that would have a smaller impact on life insurance companies. The Discussion Draft has new rules for determining the issue price in the case of an exchange of debt instruments (including by significant modification)[23]and providing that the holder of a debt instrument generally should recognize neither gain nor loss when a significant modification occurs.[24] Other proposals would make certain clerical amendments to the rules governing the taxation of certain government obligations;[25] require that the cost basis of substantially identical securities held by a taxpayer be determined on a first-in, first-out basis;[26] provide nonrecognition treatment for most derivative transactions by a corporation with respect to its own stock;[27] require the inclusion in income of interest on newly issued private activity bonds;[28] prohibit federal tax credits for newly issued mortgage credit certificates;[29] require the inclusion in income of interest on advanced refunding bonds;[30] and generally repeal the rules relating to tax credit bonds.[31]

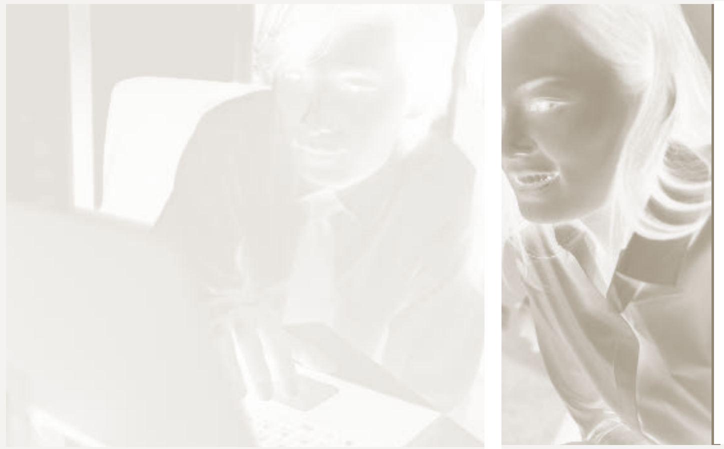
CONCLUSION

As it relates to financial products, the Discussion Draft is only the beginning of the legislative process. As work continues on tax reform, the life insurance industry should continue to bring to the attention of Congress not only the big issues, such as character mismatches and the significant impact of the market discount proposal, but also the technical problems, such as the limited tax hedge identification rule and the problems with related-party wash sale lost basis.

END NOTES

1 Draft Tax Reform Act of 2013 (financial products discussion draft) (Jan. 24, 2013), http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf.
2 Treas. Reg. § 1.446-4.
3 I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(a)(1).
4 I.R.C. §§ 1092(e), 1256(e).
5 I.R.C. § 1221(b)(2)(A)(i); Treas. Reg. § 1.446-4. A hedging transaction must also be clearly identified as such on the taxpayer's books and records on the day it is acquired, originated, or entered into. I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(f).
6 T.D. 8555 (preamble), 1994-2 C.B. 180.
7 I.R.C. § 1092(c)(1), (2).
8 I.R.C. § 1092(a)(1). Recognized gains are not deferred.
9 *Id.*
10 I.R.C. § 1256(a)(1).
11 I.R.C. § 1256(a)(3).
12 I.R.C. § 1256(a)(2).
13 Draft Tax Reform Act of 2013, § 401.
14 The American Bar Association's Section of Taxation made a similar suggestion in comments submitted to Congress, Treasury and the IRS on May 21, 2012, offering options for tax reform in the provisions of the Internal Revenue Code affecting insurers.
15 Draft Tax Reform Act of 2014, § 3402(a)(1). This proposal would treat the debt instruments as ordinary assets for purposes of determining tax hedge qualification only; they would continue to be treated as capital assets for other purposes of the Internal Revenue Code.
16 *Id.*
17 *Id.* § 3411.
18 Joint Committee on *Taxation, Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14), at 8 (Feb. 26, 2014).
19 I.R.C. § 811(b).
20 Draft Tax Reform Act of 2014, § 3422.
21 *Id.* § 3303.
22 *Id.* § 3401 (adding new I.R.C. § 486(c)(2)).
23 *Id.* § 3412(a)(1).
24 *Id.* § 3412(b)(1).
25 *Id.* § 3414.
26 *Id.* § 3421.
27 *Id.* § 3423.
28 *Id.* § 3431.
29 *Id.* § 3432.
30 *Id.* § 3433.
31 *Id.* § 3434.

SECTIONS 3504 AND 3510: COMPUTATION OF INSURANCE TAX RESERVES



By Kristin Norberg

The largest revenue-raisers among the proposed insurance reforms in the 2014 Discussion Draft are the changes to the computation of actuarial reserves. In their traditional revenue projection accompanying the Discussion Draft, the Joint Committee on Taxation anticipated a $24.5 billion increase in tax revenues over 10 years to be generated on life insurance reserves, and an additional $17.9 billion on unpaid loss reserves on contracts other than life insurance.[1]

However, the proposed reforms giving rise to these estimated revenues were actually quite narrow, focusing almost exclusively on modifying interest rate assumptions. Both the conceptual approach and the practical application create significant actuarial, economic and tax policy questions. This portion of our *Taxing Times* supplement will address primarily the changes to life insurance reserves, reviewing current law, describing the proposed revisions, and analyzing issues that arise in general and with the transition rules specifically. Since many of our readers may also work with health contracts, we will also make brief mention of the proposed changes to nonlife reserves.

CURRENT LAW

Since the enactment of the Deficit Reduction Act of 1984 (the "1984 Act"), reserves under I.R.C. § 807(d) for life insurance contracts (and noncancellable or guaranteed renewable [NC/GR] accident and health [A&H] contracts) have been computed using prescribed methods, interest rates, and mortality and morbidity tables. Each of these items is generally determined at issuance of the contract and not altered thereafter.[2] The tax reserve method is the method prescribed by the National Association of Insurance Commissioners (NAIC),[3] while the mortality and morbidity tables are those adopted by at least 26 states. In the 1984 Act, the interest rate for computing tax-basis life insurance reserves was the prevailing state assumed interest rate (PSAIR), which is the highest rate allowed by at least 26 states. Once the resulting federally prescribed reserve (FPR) has been computed, the greater of the net surrender value (NSV) or the FPR is held, but in no event will the final tax reserve be greater than the reserve held for that contract on the statutory annual statement (the "statutory cap").

In the Omnibus Budget Reconciliation Act (OBRA) of 1987,[4] Congress added a comparison to the applicable federal interest rate (AFIR) in an attempt to reflect the remarkably high market interest rates of the time. The AFIR had already been in use for discounting property and casualty (P&C) reserves; it is a 60-month average of applicable federal mid-term rates (based on annual compounding), published by Treasury each year. After OBRA 1987, life insurance reserves were required to use the greater of the PSAIR or AFIR from the year when the contract was issued. A five-year reset election was also included, allowing a company to elect to recompute the AFIR (but not the PSAIR) every five years.[5] As noted in the OBRA 1987 Conference agreement, this election was "provided to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration."[6]

Starting from OBRA 1987, other types of insurance products have also been discounted at the greater of the PSAIR or AFIR. For example, claim reserves for cancellable disability income (DI) under I.R.C. § 846(f)(6) are subject to the same rules as life insurance reserves under I.R.C. § 807(d), with some exceptions; for these contracts, the discount rate is the greater of the PSAIR determined at the year the claim was incurred (rather than at the issue year) or the AFIR.[7] Also, reserves held under I.R.C. § 807(c)(3) for insurance and annuity contracts that, at a given valuation date, do not contain life or A&H contingencies are discounted at the greatest of the PSAIR, AFIR, or the rate used to determine the guaranteed benefits.[8]

On P&C contracts and cancellable health (other than DI), current I.R.C. § 846 requires discounting at the AFIR. Insurers may use the loss payment patterns prescribed for each line of business every five years by Treasury under I.R.C. § 846(d), or they may elect under I.R.C. § 846(e) to use the insurer's own loss payment pattern.

PROPOSAL

Section 3504 of the Draft Tax Reform Act of 2014 contains the proposed changes to the Discussion Draft's changes to the computation of life insurance reserves. The primary change is to eliminate the PSAIR, redefining the valuation discount rate to equal the AFIR plus 3.5 percentage points (herein referred to as "AFIR+350bps").

CONTINUED ON PAGE 18

Since interest rates are used for several different purposes within subchapter L, there are a significant number of conforming amendments included in the Discussion Draft.[9] These range from straightforward relocation of definitions to substantive changes that could create significant impact for some insurers.

On the straightforward end, the AFIR definition is moved from I.R.C. § 846(d) to proposed § 807(d), retaining the existing determination of the rate and continuing to allow the five-year AFIR reset election. The PSAIR definition is moved from I.R.C. § 807(d) to proposed § 808, also with no substantive changes. I.R.C. § 808 defines the deduction for policyholder dividends, which include "excess interest" computed relative to the PSAIR. Proposed § 808 would be the only remaining use of the PSAIR in subchapter L, and this conforming change maintains consistency with current law in the definition of policyholder dividends.

As noted above, reserves for insurance and annuity obligations that, at the valuation date, are not life- or A&H-contingent also currently refer to the PSAIR and AFIR. For consistency with life insurance reserves, the I.R.C. § 807(c)(3) reserves would also be changed to use the AFIR+350bps (or the rate used to determine the guaranteed benefits, if greater).

I.R.C. § 811(d), which prevents a deduction for future guaranteed interest credits that exceed the greater of the PSAIR or AFIR, would be amended to refer to the AFIR+350bps. This conforming change maintains the current law's consistency between projected crediting rates and required discount rates, although it continues to take the calculation of tax reserves further afield from the underlying annual statement reserves, as we will explore further, below.

The conforming amendments also reach outside of subchapter L. I.R.C. § 954(i), which is part of the "subpart F income" computation for controlled foreign corporations (CFCs) in the active conduct of insurance business, would be amended at proposed § 954(i)(5)(B). For such insurance CFCs,[10] unlike domestic insurers, the comparison to a state (i.e., foreign regulatory) interest rate remains in place. The final discount rate under the proposal is the greater of: (A) the foreign analogue to the AFIR (determined under existing I.R.C. § 954(i)(5)(A)), plus 350bps, or (B) the highest assumed interest rate permitted for the foreign statement reserves.

Finally, one of the more problematic conforming amendments affects unpaid losses for cancellable DI insurance. The proposed § 846(f)(6)(A) would no longer include the exception that such reserves use the PSAIR in effect at incurral rather than at issue. Rather, the general rules of I.R.C. § 807(d) would apply in determining the interest rate, referring to the AFIR at issuance of the contract, plus 350bps. The previous approach conformed to statutory reserve definitions and was conceptually appropriate for the PSAIR (and also for the AFIR, though the AFIR was not explicitly included in I.R.C. § 846(f)(6)(A)). Cancellable A&H contracts typically do not have an active life reserve before a claim is incurred. The reserve for unpaid losses is first established at the point of incurral and so assets would be set aside at that time.[11] For insurers with large group disability or other cancellable DI blocks, the effect of moving from an incurral-date interest rate to an issue-date rate could be substantial; further, there would not normally be an NSV on these products to help mitigate the reduction in reserves.

On the P&C side, Draft Tax Reform Act of 2014, § 3510 outlines the changes to P&C (also affecting cancellable A&H other than DI) insurance reserves under I.R.C. § 846. The AFIR, which previously was defined in I.R.C. § 846(c)(2), would be removed and replaced with "a rate determined on the basis of the corporate bond yield curve (as defined in section 430(h)(2)(D)(i))."[12] Also, the loss payment patterns are adjusted (generally extended, delaying reserve deductions), and the election to use the company's own historical loss payment patterns is repealed.[13]

TRANSITION RULES

The 2014 Discussion Draft applies the interest rate changes to insurance reserves starting in the first taxable year beginning after Dec. 31, 2014. This date is almost certainly going to change before this or a substantially similar provision is enacted, but the transition rules do require some consideration by insurers.

For a life insurer that files tax returns on a calendar-year basis, and using the Discussion Draft's current effective dates, the new discount rate under proposed § 807(d)(4) would apply as follows:

- For life, annuity, and NC/GR A&H contracts issued in 2015 or later, the discount rate would be the AFIR for the calendar year in which the contract is issued, plus 350bps.

- For life, annuity, and NC/GR A&H contracts issued in 2014 or earlier, the 2014 tax return would be filed using the rates that arise under current law. Starting on the 2015 tax return, both opening and closing reserves would use the 2015 AFIR, plus 350bps, for all issue years. The difference (increase or decrease) as of Dec. 31, 2014, would be spread over the subsequent eight years, 2016 to 2023, in a manner essentially identical to the current I.R.C. § 807(f) spread.

It is evident that the spread duration is set to eight years (rather than the usual 10 for reserve basis changes under current law) in order to accelerate all of the resulting taxable income into the 10-year revenue estimation period. Insurers with P&C or cancellable A&H business should be cautious, though, since the transition rules are slightly different for the changes to I.R.C. § 846; in particular, the eight-year spread on unpaid losses under Draft Tax Reform Act of 2014, § 3510(e) would run from 2015 to 2022. Perhaps before any changes to reserve computations are finalized in a comprehensive tax reform package, these transition rules can be coordinated.

ANALYSIS

> *"Replacing the current-law prescribed interest rate with an interest rate based on an enhanced mid-term applicable Federal rate that generally tracks corporate bond rates over the long run would better reflect economic reality. The current-law rule that uses a regulatory-based measurement generally understates income."—Majority Tax Staff, House Committee on Ways and Means, Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary (2014), at 106.*

Perhaps one of the most striking aspects of the life insurance reserve proposal is the selection of 3.5 percentage points as the imposed adjustment. While this is intended to reflect a credit spread between the Treasuries underlying the AFIR and the corporate bonds that make up a large part of insurers' portfolios, the reality is that a static rate (*any* static rate) is an arbitrary and simplistic attempt that will have the consequence of moving away from economic income. Further, even if 3.5 percentage points does represent an average spread "over the long run," the fluctuations in reserves themselves cannot be averaged across years. That is, assume that the FPRs are computed using identical methods and assumptions to the statutory reserves, with the exception of the interest rate. Then, in years when the AFIR+350bps is higher than the statutory interest rate, the FPR would be lower than the statutory reserve. But in years when the AFIR+350bps is lower than the statutory rate, the potential offsetting "excess" FPR is eliminated since each contract's tax reserve is capped to that contract's statutory reserve.[14] The only way that a static long-term average spread could yield appropriate long-term average reserves is if the seriatim cap were removed. Short of that, the determination of an economically relevant tax reserve must use an economically based interest assumption.

In addition to limiting the sensitivity to economic conditions, the proposal also takes a step backwards in terms of acknowledging the variety of risks inherent in different types of insurance products. In the 1980 amendments to the Standard Valuation Law (SVL),[15] the NAIC developed dynamic interest rate formulas that were responsive not only to market-based reference rates, but also to the types and levels of risks sustained by a company under various product designs. For example, deferred annuities that can be surrendered for book value upon demand have much greater disintermediation and liquidity risks than an immediate annuity that guarantees annual payments for life. The SVL's dynamic formulas respond to this difference in risk by requiring a lower discount rate (higher reserve) on the deferred annuity than on the immediate. Similarly, contracts that provide longer-duration guarantees require a lower discount rate (higher reserve) than those with shorter guarantees, in significant part to allow for reinvestment risk and for volatility associated with the passage of time.

The proposal would remove the dynamic nature of the PSAIR and apply a single discount rate for all products and benefits issued in a given year, regardless of the risks inherent in each design.

The 2014 Discussion Draft decouples tax-basis life insurance reserves from this risk-oriented concept. The proposal would remove the dynamic nature of the PSAIR and apply a single discount rate for all products and benefits issued in a given year, regardless of the risks inherent in each design.

As a practical matter, the reserve provisions in the Discussion Draft would generally harm life-focused companies more

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than annuity writers, though the effects will be muted somewhat by the statutory cap and NSV floor of I.R.C. § 807(d)(1). Additionally, by using a single rate to restate reserves across all past issue years, the transition rules would tend to be more favorable for established, stable companies than for fast-growing companies. These patterns can be demonstrated through a comparison of interest rates among products and across eras.

Chart 1 illustrates historical PSAIRs (before comparison to the historical AFIRs) for sample life insurance, deferred annuity and immediate annuity contracts. Consider these as illustrative of the rates that will continue to be used for annual statement reserves, generating temporary differences in tax vs. statutory income. If the legislation became effective immediately, the new discount rate would be 5.29 percent (based on the 2014 AFIR of 1.79 percent). By comparing the statutory maximum rates to the proposed tax-basis discount rate, and recalling that higher discount rates generate lower reserves, we can make a few observations:

- Immediate annuity tax reserves would generally increase but would likely hit the statutory cap.
- Older deferred annuities would likely have both tax and statutory reserves at the NSV floor already, so the statutory-to-tax difference may not change noticeably.
- Reserves for life insurance and long-term A&H contracts, and also for deferred annuities issued in recent years, would generally decrease. For products with cash values, the NSV floor would mitigate this effect, but only to a limited extent since many contracts would still have surrender charges that reduce the NSV.

Chart 1. Comparison to Prevailing Statutory Assumed Interest Rates [16]

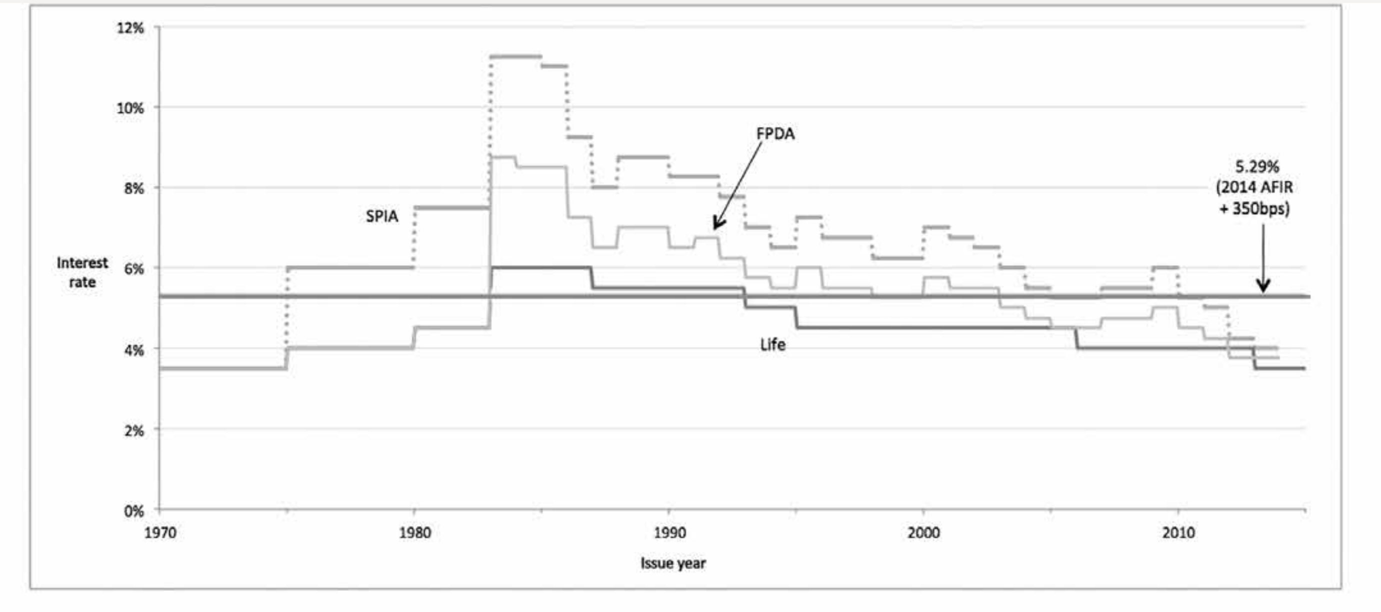
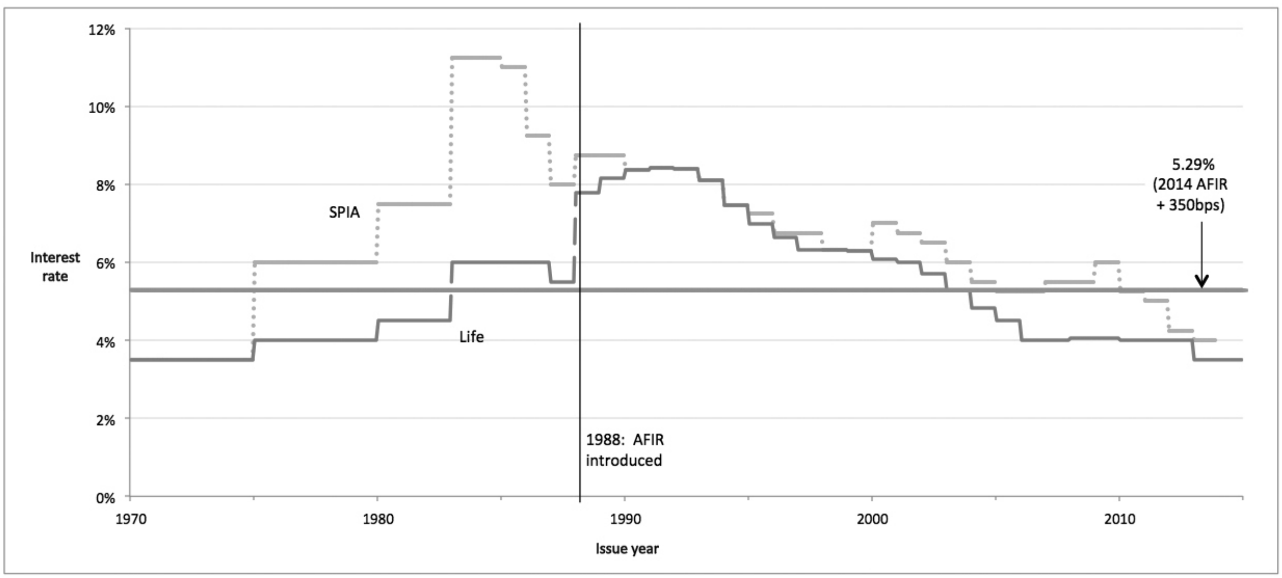


Chart 2 illustrates the life insurance and immediate annuity discount rates for tax reserves under current law; the PSAIRs are identical to Chart 1, but Chart 2 reflects the use of the historical AFIR if it exceeds the PSAIR. Consider these as illustrative of the rates currently being used for tax returns, generating the change in reserves that would be spread over eight years under the Discussion Draft's transition rules. The chart suggests that there would be, if anything, an *increase* in tax reserves on contracts of any product type issued between 1983 (when the SVL's dynamic interest rate formula became prevailing) and the mid-2000s, although the potential increase on older contracts would again be limited by the statutory cap. In contrast, for newer or fast-growing companies with the bulk of their business issued since the mid-2000s, the FPRs would decrease significantly under the proposed transition, with only partial mitigation from the NSV floor.

Chart 2. Comparison to Existing Tax Valuation Interest Rates (Greater of PSAIR or AFIR)[17]



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CLOSING THOUGHTS

The disconnection of tax reserves from statutory reserves suggested by Chart 1 is even more concerning when we consider the ever-increasing complexity of products, risks and reserving methods. As the life insurance industry continues to evolve, it could become harder to reconcile the notion of federally-prescribed assumptions and formulas with the tax policy objective to clearly reflect income. The Discussion Draft has taken a step *away* from sound insurance reserving principles by eliminating the consideration of product risk in the selection of the discount rate and by imposing a static credit spread regardless of the actual economic environment.

Note: *The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.*

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END NOTES

1 JCX-20-14, items III.F.4 and III.F.10.
2 *See* I.R.C. §§ 807(d)(3)(B), 807(d)(4)(A)(i), 807(d)(4)(B)(ii), 807(d)(5)(A).
3 For life insurance: Commissioners' Reserve Valuation Method (CRVM). For annuities: Commissioners' Annuities Reserve Valuation Method (CARVM). For health: generally two-year preliminary term.
4 OBRA 1987, P.L. 100-203, § 10241.
5 *Id.*, enacting I.R.C. § 807(d)(4)(A)(ii).
6 Committee Report for H100-495, P.L. 100-203, Title X, Part 1, Section II.F.1, at 979.
7 *See* I.R.C. § 846(f)(6)(A)(i). The other exceptions relative to I.R.C. § 807(d) are that companies shall use "a mortality or morbidity table reflecting the taxpayer's experience" rather than basing the unpaid losses on a prevailing table (see I.R.C. § 846(f)(6)(A)), and that the statutory cap is applied at the line of business/accident year level rather than to each contract individually (see I.R.C. § 846(f)(6)(A)(ii)).
8 See I.R.C. § 807(c)(3) and the flush language at the end of I.R.C. § 807(c); examples in this category include reserves on participants who have not yet annuitized in a group pension plan that guarantees life annuity purchase rates for only a temporary period, or reserves for term-certain settlement options after the insured dies on a life insurance contract.
9 There are two additional sections of subchapter L, part 1, where life insurance reserve discount rates are referenced but which do not have conforming amendments in the Discussion Draft:

The first is in determining the policyholder share for proration of dividends received and tax-exempt income, which, under current I.R.C. § 812(b)(2)(A), includes required interest at the greater of the PSAIR or AFIR. However, as described in "Section 3506 and 3508: Insurance Company Proration" on page 10 of this supplement, valuation interest rates would no longer be relevant to proposed § 812, so there is no conforming amendment.

The second is in the regulatory authorization relating to modified guaranteed contracts (MGCs) under I.R.C. § 817A. Paragraph (e)(2) of that section permits the Treasury Secretary to prescribe regulations for MGCs relative to the various uses of interest rates in part 1 of subchapter L. Such regulations were finalized in 2003 as Reg. § 1.817A-1, T.D. 9058, 5/6/2003. Various parts of the regulations (and authority therefor) would no longer be relevant if I.R.C. § 812 is modified as proposed. However, it does appear that the existing regulations would appropriately substitute the Treasury constant maturity rate for the final reserve discount rate ("applicable interest rate") under proposed § 807(d)(2)(B), rather than substituting it for the "applicable federal interest rate" under § 807(d)(2)(B)(i) and then adding the 350bps. Thus, updating the regulations would not be urgent.

10 Excluding such CFCs electing under I.R.C. § 953(d) to be taxed as a U.S. company, or receiving a ruling under I.R.C. § 954(i)(4)(B)(ii) to use foreign statement reserves.
11 Note that the selection of discount rate by incurral year would also have been appropriate for cancellable long-term care contracts, for the same reason, though again this was not included in I.R.C. § 846(f)(6).
12 Draft Tax Reform Act of 2014, § 3510(a). The rate appears to be in the 4.75 to 5 percent range at the time of this writing, compared to the 2014 AFIR of 1.79 percent.
13 *Id.*, § 3510(b).
14 I.R.C. § 807(d)(1).
15 *See* NAIC Model 820, also included in the *Accounting Practices and Procedures Manual* as Appendix A-820.
16 SPIA = single premium immediate annuity. FPDA = flexible premium deferred annuity, issue year basis, with cash settlement options, without interest guarantees on future premiums, plan type C, guarantee duration 0-5 years. Life = life insurance with guarantee duration more than 20 years. Rates obtained from Rev. Rul. 92-19, 1992-1 CB 231, and its annual successors up through Rev. Rul. 2014-4, 2014-5 IRB 449.
17 *Ibid.*

SECTION 3505: ADJUSTMENTS FOR CHANGES IN TAX RESERVE BASIS

By Tim Branch

From time to time, insurance companies find the need to change the methods and basis used to determine tax reserves. These changes can include using a different interest rate, mortality table or method in the calculations. In most instances, I.R.C. § 807(f) provides a method to recognize a change in the basis of determining tax reserves into taxable income,[1] which is unique to life insurance companies and to life contracts issued by nonlife insurance companies. This is different from the methods used by other taxpayers, who recognize changes in accounting methods under a different section of the Code (I.R.C. § 481).[2]

One of the key objectives of Chairman Camp's Tax Reform Discussion Draft is the simplification of the current Code. This includes the proposed elimination of many "insurance company-specific" provisions, such as the adjustment to income for a change in the method or basis of computing reserves under I.R.C. § 807(f).[3] In this section of the Code, a life insurance company spreads the changes in reserve basis over 10 years, instead of the treatment required under I.R.C. § 481 as discussed below. The Discussion Draft would replace the language in I.R.C. § 807(f) that outlines the 10-year spread with language that points to I.R.C. § 481. By eliminating the 10-year spread under I.R.C. § 807(f), the Discussion Draft would have the life insurance industry conform to the general accounting method change rules.

Currently, I.R.C. § 807(f) generally requires that if there is a change in basis in determining any reserve item under I.R.C. § 807(c) from one taxable year to the next, the amount of change (measured as of the end of the taxable year of change) is spread over 10 years, regardless of whether the change in basis increases or decreases reserves. Mechanically, insurers reflect one-tenth of the change in basis in each of the 10 years following the year of change.

I.R.C. § 481 differs from I.R.C. § 807(f) in three ways. First, a change in basis that results in an increase in income is treated differently from a change that results in a deduction. Second, the period over which the change in basis is spread is much shorter under I.R.C. § 481. More specifically, the spread period for a change in basis that would result in a decrease in reserves under I.R.C. § 807(c) would be spread over four years, while a change in basis that increases reserves would be taken in one year.[4] This asymmetry will result in the acceleration of a deduction resulting from a change in basis that increases tax reserves relative to those changes that lower tax reserves. Also, it is important to note that an adjustment under I.R.C. § 481 is taken into account for taxable income beginning in the year of change, while the 10-year spread under I.R.C. § 807(f) begins in the "succeeding year" after the year of change. Third, the determination of the amount of the change in basis under I.R.C. § 807(f) is the difference between the amount of the item at the close of the taxable year on the new basis and the old basis, while the amount of change under I.R.C. § 481 is determined at the beginning of the taxable year of the change in method of accounting.[5]

Typically, under I.R.C. § 481, the taxpayer must request the consent of the Secretary to change a method by means of filing Form 3115, "Application for Change in Accounting Method." However, the Discussion Draft language states that a change in tax reserve basis will be treated as if it were "initiated by the taxpayer and made with consent of the Secretary," which would eliminate the need to file Form 3115. Since the change would be treated as being initiated by the taxpayer, it can be spread over four years if decreasing reserves or deducted immediately if increasing reserves, as discussed above.

Draft Tax Reform Act of 2014, § 3505, as currently drafted, has an effective date applicable to taxable years beginning after Dec. 31, 2014. The issue of existing unamortized I.R.C. § 807(f) balances as of the effective date is not addressed, but it would be logical to assume that any existing amounts would continue to amortize over their original 10-year schedule.

The Discussion Draft modification to I.R.C. § 807(f) to eliminate the 10-year spread for changes in reserve basis, and the insertion of the I.R.C. § 481 language for adjustments required by changes in method of accounting are intended to simplify the Code and to conform the life insurance industry to the

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general accounting method change rules. Relative to other insurance-specific provisions in the Discussion Draft, this provision is expected to raise only a modest amount of revenue and is, therefore, less likely to receive significant opposition from the insurance industry.

Note: *The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.*

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END NOTES

[1] I.R.C. § 807(f) is generally not applicable to corrections of errors, or certain other changes. See Rev. Rul. 94-74 for more guidance on this topic.
[2] In general, the IRS considers the method used to determine tax reserves to be a method of accounting.
[3] Draft Tax Reform Act of 2014, § 3505.
[4] Rev. Proc. 2011-14, Section 5.04, "Section 481(a) adjustment period."
[5] Treas. Reg. § 1.481-1(c)(1)

SECTION 3512: CAPITALIZATION OF CERTAIN POLICY ACQUISITION EXPENSES

By Daniel Stringham

I.R.C. § 848 requires issuers of certain insurance products to amortize over a 120-month period, rather than immediately deduct, specified policy acquisition expenses. Amortization begins on the first month of the second half of such taxable year.[1] While specified policy acquisition expenses are ultimately deducted, amortizing these expenses thus creates a timing mismatch that increases the taxable income of the issuing company. This tax cost to the insurance company, which is generally referred to in the life insurance industry as the so-called "DAC tax," may be passed through to applicable policyholders.

Rather than require the issuing company to actually determine the amount of policy acquisition expenses attributable to each particular sale, for administrative convenience I.R.C. § 848 deems specified policy acquisition expenses to be a specified percentage of net premiums, depending upon the type of insurance product in question.[2] For example, on an annual basis, specified policy acquisition expenses are deemed to be 1.75 percent of net premiums from nonqualified annuity products, 2.05 percent of net premium from group life insurance products (excluding group corporate-owned life insurance [COLI] contracts),[3] and 7.7 percent of net premium for all other specified insurance products, e.g., individual life insurance contracts, COLI contracts, noncancellable accident and health insurance contracts, and long-term care combination contracts, such as life insurance or annuity contacts with a long-term care rider.[4] Certain types of products, such as pension plan contracts and flight insurance, are not subject to DAC tax.[5] Therefore, if an insurance company receives net premiums of $50 million during year 1 from individual life insurance contracts, the issuer is required to amortize $3,850,000 (7.7 percent of $50 million) over a 120-month period, commencing in July of year 1. An insurance company with multiple product lines would go through similar calculations for other insurance products.

Under the Camp Tax Reform Discussion Draft, the three categories of insurance products subject to DAC tax are consolidated into two categories, and the percentage of net premiums subject to amortization is increased. According to the Committee on Ways and Means, the categories of contracts and percentages were updated to reflect current expense ratios for insurance products.[6] The two categories would be group insurance products and all other specified insurance products. Specified policy acquisition expenses would then increase from 2.05 percent to 5 percent of net premiums for group insurance products. All other specified insurance products would amortize 12 percent of net premiums. This means that, for example, the percentage of net premiums amortized on nonqualified annuity products would increase from 1.75 percent to 12 percent (an increase of nearly 600 percent) and individual life insurance products and COLI contracts and noncancellable accident and health insurance contracts would increase from 7.7 percent to 12 percent. In other words, all insurance products currently subject to the DAC tax today would have a greater percentage of expenses subject to amortization under the Camp Tax Reform Discussion Draft.

While the Discussion Draft would also lower the corporate income tax rate from 35 percent to 25 percent,[7] which would offset some of the impact of new DAC tax regime, there are at least three aspects of the DAC tax proposal that should be of concern to the insurance industry. First, the impact to nonqualified annuities is so significant that the proposed corporate income tax rate decrease would only seem to offset a portion of the additional DAC tax. Second, as previously noted by Brion D. Graber and Peter H. Winslow, the DAC tax proposal seems to duplicate another provision in the Camp Tax Reform Discussion Draft that amortizes advertising expenses, which expenses are presumably already amortized under DAC tax.[8] Finally, an increase in DAC tax, without a corresponding corporate income tax cut (that is not assured in any legislative context), is simply a tax increase that the insurance company would either bear or pass along to its impacted policyholders.

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END NOTES

1. *See* I.R.C. § 848(a)(2).
2. *See* I.R.C. § 848(c).
3. *See* I.R.C. § 848(e)(2).
4. *See* I.R.C. § 848(c)(1) and (e)(6).
5. *See* I.R.C. § 848(e)(1)(B).
6. *See* Committee on Ways and Means, Chairman Dave Camp, Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary at p. 111.
7. Note that the corporate income tax rate cut is phased in over a period of years, starting at 33 percent in 2015 and grading down to 25 percent in 2019.
8. *See* "Chairman Camp's Tax Reform Discussion Draft: What Does It Mean to the Life Insurance Industry?" in this edition of *Taxing Times.*

SECTIONS 3701 TO 3705: TAXATION OF FOREIGN PERSONS

By Edward C. Clabault

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Chairman Camp's Tax Reform Discussion Draft lowers the corporate income tax rate from 35 percent to 25 percent, implements a quasi-territorial income tax system for U.S. multinationals, and provides for a repatriation holiday for earnings currently held offshore. Subpart F income is not eliminated under the new proposal, but it would be subject to a lower tax rate. Rather than making the active financing exception permanent, the 2014 Discussion Draft extends it for five years. It also includes provisions to disallow deductions for some related party reinsurance premiums and provides a more objective test for insurance companies attempting to qualify for the passive foreign investment company (PFIC) exception. In general, the 2014 Discussion Draft is a bit of a mixed bag for insurance companies, with most of the international provisions seeming to favor U.S.-based companies over their foreign-based competition.

The 2014 Discussion Draft would dramatically change the way that the United States taxes income derived by U.S. persons from their ownership in foreign corporations. This would be done through the implementation of a "participating exemption system" for foreign income. This system would provide a 95 percent deduction for the foreign-source portion of dividends received by U.S. shareholders (within the meaning of I.R.C. § 951(b)) from "specified 10-percent owned foreign corporations."[1] After exempting 95 percent of the dividends from U.S. taxation, no foreign tax credits or deduction for taxes paid would be available on these dividends. This 95 percent deduction would be available only in cases where U.S. persons owned stock in the 10 percent foreign-owned corporation for more than 180 days and would not apply to gain on the sale of stock of the foreign corporation, unless such gain were reclassified as ordinary income pursuant to I.R.C. § 1248.

In terms of the transition from the current tax system to the participating exemption system, the 2014 Discussion Draft would require that in the year preceding the year in which the participating exemption is to take effect (proposed as 2015), U.S. shareholders of controlled foreign companies (CFCs) or other 10 percent owned foreign corporation would be required to include in income their pro rata share of the foreign corporations' undistributed, non-previously taxed, post-1986 earnings and profits (E&P). The undistributed amounts would be included in the U.S. shareholder's return as subpart F income and would be eligible for a tax rate of between 3.5 percent (if reinvested in the business) and 8.75 percent (if held in the form of cash or cash equivalents). The total subpart F inclusion amount would be the U.S. shareholder's pro rata income of all foreign corporations in which it holds the required 10 percent interest, netted against any deficits from other foreign corporations in which it meets those same ownership requirements. The resulting tax would be paid by the U.S. shareholders in installments over eight years, with 8 percent of the total tax due per year for the first five years, and then 15 percent, 20 percent and 25 percent of the total liability in years 6, 7 and 8, respectively.

The 2014 Discussion Draft also makes changes to the subpart F provisions, including making the CFC look-through rule permanent, mandatory (rather than optional) use of the high tax exception under I.R.C. § 954(b), the introduction of a new subcategory of foreign base company income called foreign base company intangible income (FBCII) and a deduction for "foreign intangible income." FBCII would generally be defined by reference to the excess of the CFC's "adjusted gross income" over 10 percent of its "qualified business asset investment" (generally the adjusted basis in certain tangible property).

For insurers, the 2014 Discussion Draft brings relief, albeit temporary, to U.S.-based multinationals that have operated with a sense of uncertainty in recent years in regard to the renewal status of the Active Financing Exception. Under the Discussion Draft, the Exempt Insurance Income provision of I.R.C. § 953(e) and the Active Financing Exception under I.R.C. § 954(i) would be extended for five years with one modification. This modification, which entails a change to I.R.C. § 954(i), would limit the availability of the exemption to income that is subject to a foreign effective tax rate of 12.5 percent or more. Active financing income subject to a foreign effective tax rate less than 12.5 percent would not be excluded from foreign personal holding company income (FPHCI), but would be subject to a U.S. tax rate of 12.5 percent before foreign tax credits.

The 2014 Discussion Draft would also modify the definition of foreign base company sales income so as to exclude income of a CFC that is eligible for treaty benefits as a qualified resident of a country that has a "comprehensive income tax treaty" in force with the United States.

The 2014 Discussion Draft would statutorily override treaty protection from the 30 percent gross-basis U.S. tax in the case of "deductible related party payments" between members of a foreign-controlled group of entities, unless the U.S. tax would have been reduced by treaty if the payment had been made directly to the common foreign parent corporation of the payer and the payee. To avoid override of treaty benefits under the provision, the foreign parent corporation need not have been entitled to treaty protection equivalent to (or better than) the treaty protection to which the payee would have been entitled under the payee's treaty; the foreign parent need only be eligible for at least some treaty protection from the 30 percent U.S. tax.

For foreign-based multinationals, one item of note in the 2014 Discussion Draft is the disallowance of deductions on related party reinsurance premiums, covering property and casualty risks, paid by U.S. companies to non-taxed foreign affiliates. In most respects, the 2014 Discussion Draft mirrors that put forward by Rep. Neal and President Obama in recent years. More specifically, while it would disallow the deduction for reinsurance premiums paid, it excludes from income any related ceding commissions, reinsurance recoveries and other associated items of income. Moreover, much like the other proposals, the foreign assuming companies have the option of electing to treat amounts received from related U.S. parties as income effectively connected with a U.S. trade or business. The main significance of this provision is that now representatives from both political parties, plus the President, have put forward similar proposals. While there is little concern that this provision will pass as a stand-alone measure, many think that the ever-increasing estimated revenue figures associated with it will result in its possible inclusion as part of any future comprehensive tax legislation.

Also of interest to non-U.S. persons would be the revisions to the "earnings stripping" limitations rule under I.R.C. § 163(j) that act to defer or deny deductions for interest expenses when such interest is not subject to U.S. tax in the hands of its recipient or is owed with respect to debt that is guaranteed by a foreign or tax-exempt person. The 2014 Discussion Draft lowers, from 50 percent to 40 percent, the percentage of the taxpayer's adjusted taxable income that serves as the general benchmark for determining whether its interest expense is "excess interest expense." The 2014 Discussion Draft would also eliminate recourse to the taxpayer's prior three years' "excess limitation" to increase this threshold.

In recent years, numerous offshore reinsurance companies have been formed that have U.S. persons as owners, but as a result of dispersed ownership and the absence of related party insurance income, do not qualify as CFCs under current U.S. tax law. These entities further assert that they are predominantly engaged in the insurance business, thus qualifying for the exception from PFIC status found in I.R.C. § 1297(b). In reaction to concerns that these entities are not proper insurance companies, the 2014 Discussion Draft modifies the requirements for meeting the PFIC exception by replacing the "predominantly engaged in an insurance business" test with a test based on the gross receipts of the company. Under the proposal, an offshore insurer seeking an exception from PFIC status must meet the following criteria: 1) more than 50 percent of its gross receipts for the year must consist of premiums; 2) the insurer would have been subject to tax under subchapter L if it were a domestic corporation; and 3) its "applicable insurance liabilities" must constitute more than 35 percent of its total assets as reported on its financial statement for the year. For purposes of this proposal, "applicable insurance liabilities" means unpaid losses and loss adjustment expenses, unearned premiums and life and health reserves (other than deficiency or contingency reserves).

In general, the 2014 Discussion Draft would bring the U.S. tax system closer to that of other industrialized democracies. Although the 25 percent corporate income tax rate is much lower than what exists today, it would still be higher than that found in such places as the United Kingdom and Ireland.

END NOTES

[1] A "specified 10-percent owned foreign corporation" is defined as any foreign corporation if any domestic corporation owns directly, or indirectly through a chain of ownership descried under I.R.C. § 958(a), 10 percent or more of the voting stock of that foreign corporation.

PROVISIONS AFFECTING LIFE INSURANCE PRODUCTS AND POLICYHOLDERS

By Craig R. Springfield and Alison R. Peak

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As summarized below, Ways & Means Committee Chairman Camp's draft legislation (presented as a "Discussion Draft") contains a number of provisions relating to life insurance products and qualified retirement plans.[1]

PROVISIONS RELATING TO LIFE INSURANCE PRODUCTS

General Income Tax Treatment of Life Insurance and Annuities Left Intact. Under current law, interest and other earnings that increase cash values under life insurance and annuity contracts (i.e., the so-called "inside build-up") are taxable only if and when there is a distribution from a contract, and in the case of life insurance, death benefits generally are received tax free. As discussed above on page 7, the Discussion Draft leaves intact this general income tax treatment of life insurance and annuity contracts and thus preserves tax deferral for a contract's inside buildup. In this regard, the executive summary released in connection with the Discussion Draft states that it "does not change the current tax law incentives for individuals who purchase life insurance products to provide financial protection for themselves and their families, including continuing the long-standing practice of exempting 'inside build-up.'"[2]

COLI Interest Disallowance Rule. I.R.C. § 264 places limitations on the deductibility of interest under life insurance policy loans, and I.R.C. § 264(f) extends the reach of this section to interest accruing on unrelated indebtedness that is considered allocable to unborrowed policy cash values under life insurance and annuity contracts. However, an exception to this treatment under I.R.C. § 264(f) currently applies with respect to contracts that cover officers, directors, employees, and 20 percent owners of the taxpayer at the time first covered by the contracts. The Discussion Draft would repeal the portion of this exception that currently allows businesses to purchase corporate-owned life insurance (COLI) on the lives of employees, officers or directors, and thus it would retain the exception only in the case of coverage of 20 percent owners.[3] The effect of disallowing interest deductions has a financial consequence that is comparable to a direct tax on the inside build-up of life insurance, and thus limiting the exception to 20 percent owners would have a far-reaching impact on the current COLI market. The Discussion Draft would grandfather existing contracts, but any material increase in the death benefit or other material change in a contract would cause it to be treated as a new contract. The provision would raise $7.3 billion in revenue over 10 years. A similar proposal was included in the Administration's FY 2015 budget proposal.

Transfers of Policies for Value. With respect to transfers of life insurance policies for value, such as in a life settlement transaction, the Discussion Draft imposes reporting requirements for such transactions and also modifies the transfer for value rule in I.R.C. § 101(a)(2) to limit the exceptions to this rule. In addition, the Discussion Draft clarifies that a taxpayer's adjusted basis in a life insurance contract is not reduced for certain charges, including cost of insurance charges.

Present law generally provides that the death benefit payable under a life insurance contract is excludable from gross income under I.R.C. § 101(a). However, if an owner transfers a life insurance contract or any interest therein for valuable consideration, I.R.C. § 101(a)(2) provides that only the portion of the death benefit equal to the consideration paid for the contract (i.e., the amount paid in purchasing the contract and subsequent premiums) is excludable from gross income. However, this transfer for value rule does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract ("carryover basis exception"), or (2) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Under the Discussion Draft, the two exceptions to the transfer for value rule would not apply if the acquirer of the life insurance contract has no substantial relationship with the insured apart from the acquirer's interest in the contract.[4] A similar provision was included in the Administration's FY 2015 budget proposal except that the carryover basis exception would continue to apply. The Discussion Draft's provision, combined with the life settlement reporting and tax basis clarification provisions described next, was projected by the Joint Committee on Taxation to raise $200 million in revenue over 10 years.[5]

Currently no information reporting is required when a life insurance contract is sold. The Discussion Draft would require reporting by every person who acquires a life insurance contract (or any interest in such a contract) with a death benefit equal to or exceeding $500,000 in a reportable sale, i.e., where the acquirer has no substantial family, business or financial relationship with the insured.[6] In particular, the acquirer would report information about the purchase to the IRS, to the insurance company, and to the seller. However, the statement the buyer provides to the insurance company would not need to identify the purchase price for the contract. In addition, upon the payment of any death benefits to the acquirer, the insurance company would be required to report the gross benefit payment, the identity of the buyer, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

In 2009, the IRS published Rev. Rul. 2009-13,[7] which provided that when a life insurance contract is sold, a taxpayer's adjusted basis under I.R.C. § 1011 will be reduced by previously imposed cost of insurance charges. The Discussion Draft would clarify, however, that a taxpayer's adjusted basis would not be reduced by mortality, expense or other reasonable charges, regardless of whether the taxpayer settles or sells the contract. This clarification would be effective for transactions entered into after Aug. 25, 2009, i.e., the effective date of Rev. Rul. 2009-13.

PROVISIONS RELATING TO RETIREMENT PLANS

The Discussion Draft also would make significant changes for the tax treatment of qualified retirement plans. While the proposals affecting retirement plans are too numerous to separately describe here, we have identified several provisions that are pertinent to insurance products.

IRAs. The Discussion Draft would significantly modify the current structure of IRAs.[8] Many of the changes are designed to encourage investment in Roth IRAs. First, it would disallow new traditional IRA contributions, except for rollovers. Second, it would eliminate the current law income limits for contributing to Roth IRAs. Third, it would suspend the inflation adjustment of the annual limit on Roth IRA contributions for 10 years. In other words, contributions each year would remain capped at $5,500 (plus $1,000 in catch-up contributions for account holders age 50 or older). Fourth, it would repeal the special rule permitting the recharacterization of Roth IRA contributions as traditional IRA contributions.

Designated Roth Contributions. With respect to qualified retirement plans, the Discussion Draft would modify the contribution rules for 401(k), 403(b) and 457(b) plans by requiring employers with more than 100 employees to offer Roth accounts.[9] For participants in those plans, only half of the elective deferral limit could be made on a pre-tax basis and the remaining amount would need to be Roth contributions. The Discussion Draft would also permit employers to have Roth accounts under SIMPLE IRAs.

Required Minimum Distributions. The Discussion Draft adopts a provision that was also in the Administration's FY 2015 budget proposal that modifies the required minimum distribution rules under I.R.C. § 401(a)(9).[10] Specifically, post-death "stretch" payments would be available only for certain eligible classes of beneficiaries (such as spouses). All other post-death distributions would have to be made within five years of death. In addition, the rules governing 5 percent owners and their required beginning date would be modified.

> The Discussion Draft largely retains the Code's existing structure for the tax treatment of individuals who purchase life insurance and annuity contracts.…This being said, a number of other provisions in the Discussion Draft clearly would have an adverse effect on insurance companies and the products they issue.

Qualified Retirement Plan Contribution Limits. The Discussion Draft suspends the inflation adjustments to the qualified retirement plan contribution limits by holding these limits at the 2014 level through 2023.[11] The draft would also repeal the special catch-up contribution rules for 403(b) plans and governmental 457(b) plans.

Nonqualified Deferred Compensation Plans. The Discussion Draft includes provisions that would completely overturn the principles that have governed the taxation of nonqualified deferred compensation.[12] Under the draft, any compensation deferred under such a plan attributable to services after 2014 would be subject to taxation when there is no longer a "substantial risk of forfeiture," i.e., when amounts vest, even though such compensation might be lost in certain circumstances such as

CONTINUED ON PAGE 30

upon an employer's insolvency. The provision would apply to deferrals after 2014, thus grandfathering previously deferred amounts. The grandfather would expire, however, in 2022.

CONCLUSION

The Discussion Draft largely retains the Code's existing structure for the tax treatment of individuals who purchase life insurance and annuity contracts, which is appropriate given that it is highly questionable whether the inside build-up treatment of such contracts should be considered as a tax expenditure in the first instance. This being said, a number of other provisions in the Discussion Draft clearly would have an adverse effect on insurance companies and the products they issue, such as the increase in the deferred acquisition cost (DAC) tax, the change to the interest rate used for calculating the federally prescribed reserve, and the change to the dividends received deduction (DRD) (each of which are described in more detail in other articles in this Supplement). These provisions could affect the products that insurers focus on in their product portfolios and the pricing of such products to consumers. Further, many in the benefits community feared that the Discussion Draft would substantially reduce defined-contribution plan limits. While no such sweeping reduction is imposed, there are a number of other changes that raise significant questions. For example, the proposals to limit pre-tax contributions to qualified retirement plans, require any additional employee contributions to be made to a Roth account, and require all future IRA contributions to be made in Roth form could reduce the incentive for individuals to save for retirement. Finally, even though it is unlikely that tax reform will occur this year, there is a risk that the Discussion Draft provisions will serve as fodder for those seeking revenue raisers under legislative proposals not directed at tax reform, where thoughtful and sound tax policy considerations may be given short shrift.

END NOTES

1 The Discussion Draft legislation is available at: http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft__022614.pdf.
2 The Discussion Draft executive summary is available at: http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.
3 Draft Tax Reform Act of 2014, § 3501.
4 Draft Tax Reform Act of 2014, § 3515.
5 JCX-20-14, items III.F.13 through III.F.15.
6 Draft Tax Reform Act of 2014, §§ 3513-3514.
7 2009-21 I.R.B. 1029.
8 Draft Tax Reform Act of 2014, §§ 1601-1604.
9 Draft Tax Reform Act of 2014, § 1613.
10 Draft Tax Reform Act of 2014, § 1614.
11 Draft Tax Reform Act of 2014, §§ 1620-1624.
12 Draft Tax Reform Act of 2014, § 3801.

EPILOGUE

By Marc Rockower

The sections discussed in this Supplement highlight the key Discussion Draft provisions that specifically relate to life insurance companies and their products. This Supplement would not be complete, however, without observing further that life insurance companies are also subject to the tax rules of general applicability. The Discussion Draft contains several noninsurance-specific provisions that also have a potentially significant impact on the life insurance industry. Accordingly, life insurance company tax professionals will find it useful to focus on these items as well.

In addition, there are a number of provisions that are specifically applicable to property and casualty (P&C) insurance companies that have also been referred to in the previous sections of this document. For those life insurance companies that have significant P&C operations, it is also useful to focus on those provisions.

This epilogue will focus on both the general corporate tax provisions that are applicable to the insurance industry and the P&C tax provisions of the Discussion Draft.

GENERALLY APPLICABLE CORPORATE TAX PROVISIONS

Describing all of the general tax provisions is beyond the scope of this Supplement. Hence, the purpose of this epilogue is to underscore some of the Discussion Draft's general tax items that may be particularly meaningful to insurance companies, as well as to point to select other items that may be of interest.

Among the headlines, of course, are the proposed adjustment in corporate tax rates to 25 percent and the repeal of the alternative minimum tax. These are duly noted in the main sections of this Supplement. Following are some of the additional items.

Loss Utilization. The Discussion Draft would conform the operations loss deduction carryback/carryover rules for life insurance companies to the rules applicable to net operating losses (NOLs) of non life insurance companies. Under current law, the carryback period available to life insurance company operations loss deductions is three years and the carryforward period is 15 years. In contrast, the carryback period available to other corporate (including P/C insurance companies) NOLs is two years and the carryforward period is 20 years. The Discussion Draft would conform the life insurance rules to match those for other corporations.

While this presents a significant change, the impact of the Discussion Draft may be even greater as a result of the fact that it does not eliminate or otherwise modify the life/nonlife consolidation rules that limit the use of nonlife losses against life income. As a result, it fails to conform the current law rules directing the cross-utilization of losses among life and nonlife subgroups. The Discussion Draft further complicates matters in this regard by limiting the use of a company's NOL carryover or carryback to 90 percent of its pre-NOL taxable income.[1]

Various Deduction Items. Attention also should be paid to the manner in which the Discussion Draft would modify selected deduction items. For example, the Discussion Draft would alter the treatment of expenses relating to such items as:

- Advertising — In general, the Discussion Draft provides that 50 percent of certain advertising expenses would be currently deductible and 50 percent would be amortized ratably over a ten-year period.
- Research and experimentation — The Discussion Draft would require that such expenditures be amortized over a five-year period.[2]
- Entertainment — Under the Discussion Draft, no deduction would be permitted for entertainment-type expenses.[3]
- Local government lobbying — Amounts paid for such expenses would no longer be deductible.

The amounts that any given company would incur for these types of expenses will vary, and the Discussion Draft contains many other adjustments to the current tax code's general business expense and credit items. A key point, however,

CONTINUED ON **PAGE 32**

relates to the fact that insurance companies—be it life insurance companies through the deferred acquisition cost (DAC) provisions or nonlife insurance companies by virtue of the proration rules—are already required to adjust the rate or amount of general business expenses they may deduct. As a result, should the above changes take effect, it would result, in many instances, in a "double hit" to insurance companies unless some conforming modification is made to the manner in which the DAC and proration rules are applied.

Intangibles. Over the course of the last decade or so, there have been numerous public discussions within the insurance industry involving intangible assets held or acquired by insurance companies. Issues have involved such things as the value of a block of business, the treatment of a workforce in place, the application of the purchase price and basis allocation rules under deemed asset acquisitions, and the interplay of the I.R.C. § 197 intangible asset amortization rules and the I.R.C. § 848 DAC provisions.

Given the nature of the insurance business, concern over the proper measurement of intangibles is both complex and meaningful. Under current law, value attributable to acquired intangible assets is amortizable on a straight-line basis over 15 years. The Discussion Draft would extend this 15-year period to 20 years. Should this change be enacted, it could have a meaningful impact on the trading value of blocks of insurance or entire insurance businesses.

Interest Deduction Limitations. The Discussion Draft includes a proposal that would change the general rule in I.R.C. § 265 that limits the deduction of interest on debt incurred to purchase or carry tax-exempt securities. Under current law, there are two potential methods that I.R.C. § 265 uses to prevent taxpayers from engaging in tax arbitrage that would otherwise allow the deduction of interest on debt used to purchase tax-exempt obligations. The first method (which applies to all taxpayers) disallows the deductibility of interest on debt used to "purchase or carry" tax exempt obligations. The other method (which applies to "financial institutions and dealers in exempt securities") disallows interest deductions based on the percentage of the taxpayer's assets comprising of tax-exempt obligations. This second method does not apply to insurance companies under current law.

The proposal in the Discussion Draft would apply the pro rata disallowance rule to all C corporations, including insurance companies. Thus, for those companies, the interest deduction would be disallowed based on the percentage of the taxpayer's assets that are comprise of tax-exempt obligations. Similar to the above expense items, the Discussion Draft would decrease a potential deduction item that is already reduced or deferred under the insurance company DAC and proration rules.

Accounting for the Transition to 25 Percent Rate and Other Changes. Accounting Standards Codification ASC 740-10-35-4 provides that deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. In addition, a change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets.

Furthermore, ASC 740-10-45-15 provides that when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.

Pursuant to these financial accounting rules, the Camp Discussion Draft's reduction in tax rates will have an impact on insurance companies' deferred tax assets/liabilities once enacted. The change in rate would require an adjustment to the deferred tax asset/liability balances for both GAAP and statutory accounting. In addition, the change in the NOL carryback and carryforward rules for life insurance companies would impact the admissibility of deferred tax assets for statutory accounting purposes under the Statement of Statutory Accounting Principles (SSAP) 101 formula for admitting deferred tax assets.

SOME ADDITIONAL INSURANCE COMPANY ITEMS

Before concluding, it should be noted that the Discussion Draft also contains some insurance-specific items that are not covered in detail in the above sections of this Supplement.

Two of them apply to life insurance companies.

- Repeal of the "small life insurance company deduction"—The Discussion Draft repeals the "small life insurance company deduction" under I.R.C. § 806, which provides a life insurer with assets worth less than $500 million and taxable income (determined without the small life insurance company deduction) of less than $15 million a deduction equal to 60 percent of the first $3 million of taxable income, reduced by 15 percent of taxable income exceeding $3 million.

- Repeal of the I.R.C. § 815 tax on "Phase III" income —The Discussion Draft also repeals I.R.C. § 815, which subjects life insurers in existence before 1984 to tax on "Phase III" income, measured by reference to certain deemed distributions from amounts accumulated in "policyholders' surplus accounts," amounts that ceased accumulating after changes in the tax rules applicable to life insurers in 1984. Any remaining "Phase III" balance as of Dec. 31, 2014, would be included in taxable income ratably over eight years beginning in 2015.

P&C INSURANCE TAX PROVISIONS

In addition to the provisions of general corporate applicability, there are also provisions directed specifically toward the nonlife insurance companies. This Supplement doesn't specifically address the impact of these provisions on the P&C industry, but it is reasonable to conclude their impact will be significant. They are as follows:

- Revise the P&C proration rules[4]—Under current law, a P&C company is required to reduce reserve deductions by a flat 15 percent of the sum of its tax-exempt income, its dividends received deduction (DRD), and any increase in cash value of life insurance or annuity contracts. The Discussion Draft would change the proration rules to reduce deductions in an amount equal to the ratio of the company's tax-exempt assets (i.e., those assets giving rise to the income that is subject to proration as defined above) to all of its assets.

- Repeal the special rules in I.R.C. § 833 for Blue Cross and Blue Shield (BC/BS) organizations—BC/BS organizations became taxable as P&C insurance companies under I.R.C. § 832 in 1986. In conjunction with treating them as taxable insurance companies, special rules were adopted that provide BC/BS organizations in existence in 1986 (and certain "other organizations" deemed to be operating in the same manner) with a "special deduction" equal to the amount by which 25 percent of losses and claims incurred, plus expenses, on insurance and "cost-plus" contracts exceeds the company's "adjusted surplus" and exclude these organizations from the rule under I.R.C. § 832 requiring current inclusion in income of 20 percent of unearned premiums. The Camp Discussion Draft would repeal these special tax benefits for BC/BS organizations.

- Change the discount rate rules applicable to unpaid loss reserve deductions for P&C companies[5]—The bill would require P&C companies to use Treasury's corporate bond yield curve to determine the discount. In addition, the special rule under current law that extends loss payment pattern periods for long-tail lines of business would apply similarly to all lines of business for consistency. Finally, under the Discussion Draft, the election to use company-specific, rather than industry-wide, historical loss payment patterns, would be repealed.

- Repeal the elective deduction available to insurance companies under I.R.C. § 847—The Discussion Draft would eliminate the elective deduction that insurance companies could claim under current law equal to the difference between a company's reserves computed on a discounted basis and reserves computed on an undiscounted basis. Currently, companies that make this election must make a special estimated tax payment equal to the tax benefit attributable to the deduction.

CONCLUSION – BUSINESS IMPLICATIONS AND NEXT STEPS FOR INSURANCE COMPANIES

While tax professionals in the life insurance sector are typically focused on the implications of these potential changes on the tax position of the companies they represent, or the impact on the products they sell, other professionals in such organizations may also need to consider how the changes in individual tax rates may alter the marketability of their products in the first instance. While this may not be a tax issue, it is one that tax professionals may be called upon to provide advice on within their organizations, and for which the impact on the company may be even greater than the company or product tax issues they usually deal with.

It also suggests the need for heightened attention within insurance organizations to the impact tax reform could have on them, and the need to continue to analyze the results of potential

CONTINUED ON **PAGE 34**

changes, so they know both the magnitude of the impacts of tax reform and are informed as to their need to be engaged in the legislative process as it moves forward.

Part of this might necessitate a continuing education process among the insurance industry and lawmakers so there is a common understanding as to the impact of specific proposals on the industry and lessons learned from prior reform efforts, including discussion around policy goals that may or may not have been achieved through prior legislation.

Note: *The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.*

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END NOTES

[1] The modification of the operations loss deduction for life insurance business adds similar opportunity for complexity when one also considers the special loss carryover rules under I.R.C. § 844.

[2] The Discussion Draft would, however, make permanent a modified research credit. Important to insurance companies, the provision would retain the rule under the alternative simplified credit that allows a taxpayer to claim a reduced research credit if the taxpayer has no qualified research expenses in any one of the three preceding tax years; thus, making it easier for taxpayers to substantiate their credits than under the current regular credit.

[3] The 50-percent limitation under current law also would continue to apply to expenses for food or beverages and to qualifying business meals.

[4] See also, "Sections 3506 and 3508: Insurance Company Proration," page 11.

[5] See also, "Sections 3504 and 3510: Computation of Insurance Tax Reserves," page 18.

ACLI UPDATE:

CHAIRMAN CAMP'S TAX REFORM DISCUSSION DRAFT

By Pete Bautz and Mandana Parsazad

As discussed throughout this Supplement, on Feb. 26, 2014, House Ways & Means Chairman Dave Camp released a comprehensive tax reform discussion draft (the "2014 Discussion Draft") that would reduce both individual and corporate statutory income tax rates and transition to a participation exemption system for taxing the international income earned by foreign subsidiaries of U.S. corporations. The reduced rates and exemption system would be paid for by eliminating or reducing many tax deductions, credits or perceived "tax loopholes." The 2014 Discussion Draft contains several new provisions that propose to change the income taxation of life insurance companies and products. The most significant among them are:

- Draft Tax Reform Act of 2014, §3503, Repeal small life insurance company deduction;
- § 3504, Computation of life insurance tax reserves;
- § 3505, Adjustment for change in computing reserves;
- § 3506, Modification of rules for life insurance proration for purposes of determining the dividends received deduction;
- § 3512, Capitalization of certain policy acquisition expenses;
- § 7004, Excise tax on systemically important financial institutions; and
- § 3501, Exception to pro rata interest expense disallowance for corporate-owned life insurance restricted to 20 percent owners.

On March 19, 2014, Americans to Protect Family Security Coalition, a partnership of America's life insurance companies, agents, financial advisors and insurance trade associations, including the American Council of Life Insurers (ACLI), sent a letter to Chairman Dave Camp explaining that the 2014 Discussion Draft, if implemented, would impose new taxes that would adversely impact the ability of families and businesses to protect against risk and plan for their long-term financial security.

On April 2, 2014, 78 ACLI member company CEOs submitted a letter to Chairman Camp noting that the 2014 Discussion Draft recognizes the value of many individual products the life insurance industry provides to consumers. However, as in the March 19 letter, the April 2 letter highlighted that the provisions would collectively impose new taxes on life insurance companies, products and retirement savings and would adversely impact the ability of families and businesses to protect against risk and plan for their long-term financial security.

ACLI has been working closely with its members to study the current taxation of life insurance companies and products and the effect the 2014 Discussion Draft would have on the life insurance industry and its consumers. This detailed analysis should serve to inform tax reform discussions with accurate information about the life insurance industry and its products.

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