



1	TAXING TIMES: The First Ten Years By Brian G. King, Kristin Norberg and members of the editorial board
2	From The Editor To Our Readers By Kristin Norberg
4	From The Chair By Tim Branch
11	In the Beginning ... A Column Devoted to Tax Basics By Gary R. Vogel and Kristie Khaw
15	Private Letter Ruling on Section 807(f) Refines Change-in-Basis Rule By Craig Pichette and Sheryl Flum
22	Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC Part I: Tax Reserves Peter Winslow (moderator), John T. Adney, Timothy Branch, Sheryl Flum, Susan Hotine, Mark S. Smith,
34	Reporting the Costs and Benefits of the 3Rs By Maureen Nelson, Matthew Haaf and Megan Lansden
39	The Second Edition of Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A By John T. Adney, Brian G. King, and Craig R. Springfield
42	ACLI Update By Pete Bautz and Mandana Parsazad
43	T³: TAXING TIMES Tidbits

TAXING TIMES: THE FIRST TEN YEARS

By Brian G. King, Kristin Norberg, and members of the editorial board

May 2005 marked the inaugural issue of TAXING TIMES, the newsletter of the newly-formed Taxation Section of the Society of Actuaries. In the spring of 2015, we recognize this milestone with a trip down memory lane.

With this 10th anniversary edition of *TAXING TIMES*, the editorial board thought it would be enjoyable for our readers to take a journey back through the past decade, revisiting many of the achievements *TAXING TIMES* has had over its relatively short lifespan, and recognizing the contributions of the volunteers who helped shape *TAXING TIMES* into a respected actuarial resource for life insurance tax practitioners.

The Birth of a Newsletter... The journey began back in 2004 with the creation of the Taxation Section. Having felt that insurance tax was an underserved segment within the Society of Actuaries section structure, the likes of Barbara Gold, Ed Robbins and Chris DesRochers started a movement to create a new section to serve the tax needs of our actuarial community. Under the leadership of Ed Robbins, the Taxation Section was born. One of the first orders of business was to create a newsletter to share insurance tax-related content with its members.

CONTINUED ON **PAGE 6**

Taxing TIMES

2015 SECTION LEADERSHIP

Chairperson

Timothy Branch, FSA, MAAA

Vice Chairperson

Jeffrey Stabach, FSA, MAAA

Secretary/Treasurer

James Van Etten, FSA, MAAA

Council Members

Mark Biglow, ASA, MAAA

Lawrence Hersh, FSA, MAAA

Brian McBride, FSA, MAAA

Kristin Norberg, ASA, MAAA

Donald Walker, ASA, MAAA

Jacqueline Yang, FSA, MAAA

Affiliate Council Member

John T. Adney, Esq.

Board Partner

Kory Olsen, FSA, CERA, MAAA

NEWSLETTER STAFF

Editor

Kristin Norberg

Associate Editors

Frederic J. Gelfond

Brian G. King

Gregory Stephenson

Editorial Board

John T. Adney

Mary Elizabeth Caramagno

Sheryl Flum

Samuel A. Mitchell

Arthur Schneider

Mark S. Smith

Daniel Stringham

SOA STAFF

Kathryn Baker

Staff Editor

e: kbaker@soa.org

Jennifer Foster

Lead Section Specialist

e: jfoster@soa.org

Beth Bernardi

Staff Partner

e: bbernardi@soa.org

Anna Matras

Graphic Designer

Published by the Taxation Section Council of the Society of Actuaries

This newsletter is free to section members. Current issues are available on the SOA website (www.soa.org).

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

This publication is provided for informational and educational purposes only. The Society of Actuaries makes no endorsement, representation or guarantee with regard to any content, and disclaims any liability in connection with the use or misuse of any information provided herein. This publication should not be construed as professional or financial advice. Statements of fact and opinions expressed herein are those of the individual authors and are not necessarily those of the Society of Actuaries.

© 2015 Society of Actuaries. All rights reserved.

FROM THE EDITOR TO OUR READERS

By Kristin Norberg

Welcome! In this edition, we celebrate ten years of *TAXING TIMES* with a special look back through our first decade (page 1). Thirty regular issues (this is the 31st), five supplements, and thousands of hours from dozens of volunteers ... it's been a great ride!

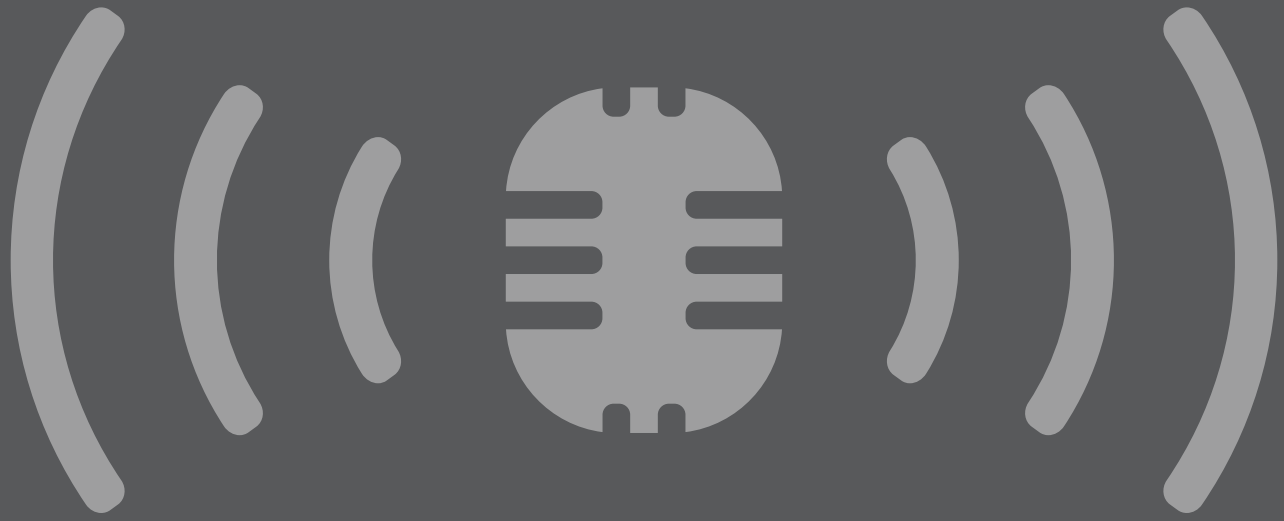
Also in this issue, we take a look at some of the key concepts of the Affordable Care Act (ACA) with an article about the ACA's three risk-regulating mechanisms, by authors Maureen Nelson, Matthew Haaf, and Megan Lansden (page 34). Health concepts, particularly relating to short-duration products, admittedly have not gotten much attention in *TAXING TIMES* in the past, and as we go to press awaiting the Supreme Court's ruling on *King v. Burwell*,¹ we recognize that this is an important time to examine them.

We also are including a paired set of articles—an “In the Beginning...” column along with a *TAXING TIMES* Tidbit—in a structure we hope to use in future issues as well. At the beginning of 2015, the Internal Revenue Service released what quickly became a highly-contentious Chief Counsel Advice memorandum (CCA 201501011). The CCA addressed the issue of whether Internal Revenue Code section 197 requires the capitalization and amortization of a ceding commission (specifically, that portion in excess of the amount capitalized under the so-called “DAC tax” rules of section 848) in a reinsurance transaction that is accounted for as indemnity reinsurance for statutory reporting purposes and that is treated as a section 1060 applicable asset acquisition for federal income tax purposes. Many in our actuarial audience may be saying to themselves right now, “Okay, I know what the DAC tax is, but what’s all this other stuff, and does it have anything to do with my career?” Well, I encourage those readers to start with the “In the Beginning... A Column Devoted to Tax Basics” column, by Gary R. Vogel and Kristie Khaw (page 11), to explore the various tax structures that may apply to business purchases in general and reinsurance transactions specifically. They will introduce you to sections 197, 1060, and also 338, and explain some of their key impacts on insurance companies. With that grounding, you can then launch into Lori J. Jones’ Tidbit on CCA 201501011 (page 43), and start to understand some of the controversy and debate that has followed its release. In addition, you’ll be able to gain some familiarity with tax concepts that are central to the profitability and feasibility of business combinations, so you can start to collaborate more effectively with tax and accounting colleagues when such opportunities arise.

As always, we thank all of our authors and editors for their important contributions, and we hope you enjoy reading the 10th-anniversary issue of *TAXING TIMES*!

END NOTES

¹ Note: The Court's opinion was released on June 25, 2015, at 576 U.S. ____ (2015), ruling in favor of the government in administering subsidies to individuals who purchase insurance on federally-sponsored health exchanges in states that did not establish their own exchanges.



Did You Know?

The SOA Taxation Section has published podcasts of *TAXING TIMES* articles that you can download on iTunes or from the Taxation Section's webpage on SOA.org! Perfect for your commute, a long run, or wherever you like to listen and learn. Currently, there are 18 podcasts available, including these most recent titles:

Episode 17: In the Beginning...Tax Accounting for Insurance Companies

Length: 8:04

Dan Theodore reads "In the Beginning...Tax Accounting for Insurance Companies" from the February 2015 issue of *TAXING TIMES* written by Stephen R. Baker

Episode 18: IRS and Treasury Release 2014 - 2015 Priority Guidance Plan

Length: 7:42

Dan Theodore reads "IRS and Treasury Release 2014-2015 Priority Guidance Plan" from the February 2015 issue of *TAXING TIMES* written by Robert A. Shanahan and Mark S. Smith.

Thanks to Dan Theodore (Milliman) and Jacqueline Yang (KPMG LLP) for recording the podcasts, and to the authors for making their work available in this format.

FROM THE CHAIR

COMING SOON, TO A THEATER NEAR YOU

By Timothy Branch

As I write this “From the Chair” column, it’s mid-March; time to file personal tax returns, dig out from a tough winter (for those of us in the Northeast, at least) and cheer for our favorite college basketball teams during the NCAA tournament (although there is not a lot to cheer for if you’re pulling for last year’s champions, the University of Connecticut Huskies). It’s also time to look forward to this year’s upcoming meetings, symposia, boot camps and webcasts. Taking a quick look at the SOA’s online professional development calendar, one can see that there is a plethora of continuing education opportunities, offered in a variety of locations and formats.

The Taxation Section will again be well represented at many of these events; the Life and Annuity Symposium in New York, the Valuation Actuary Symposium in Boston, and the 2015 SOA Annual Meeting & Exhibit in Austin. We’ll be covering our usual topics, including company and product tax updates and primers. In the past, these sessions have been well-received and highly rated by participants, and provide good foundational and current information related to tax topics of interest to actuaries.

However, we should also look for new opportunities to keep the content on the leading edge. As our section grows and changes, we’d like to hear from our members on what tax topics they would like to hear more on, and how they would like to hear about them (meeting sessions, webinars, podcasts, etc.). One of the ways we can create fresh content is to collaborate with other sections. If you are member of one or more sections in addition to the Taxation Section, think about topics that span both tax and your other areas of interest (financial reporting, risk management, health, modeling, or futurism to name a few). We should all think of ways to keep our section current and innovative, and improve our presence within the Society of Actuaries continuing education lineup.

And the most important item in creating new, innovative Taxation Section sponsored learning opportunities is ... You. Yes, you. The Taxation Section is always looking for volunteers to share their knowledge by presenting at Society of Actuaries learning events or writing content for *TAXING TIMES*. If you are interested in volunteering, please reach out to the Taxation Section Council, or the Society of Actuaries staff or section specialists. This is our section, and is up to us to maintain our reputation as the premiere source for tax-related information for actuaries.

I look forward to hearing from all of our future volunteers! ◀

Timothy Branch, FSA, MAAA, is a manager at Ernst & Young LLP and may be reached at tim.branch@ey.com.

SOCIETY OF ACTUARIES

SOA PROFESSIONALISM READY-TO-GO KIT



HOST A TOP-NOTCH PROFESSIONALISM WORKSHOP FOR YOUR EMPLOYEES (WITHOUT LEAVING THE OFFICE)

Check out the **Professionalism Ready-to-Go Kit**, which uses real-life scenarios to provide ample opportunities for group discussion in your office.

- Includes a facilitator guide, logistics guide, slide presentation and participant guide
- Participants may attain Continuing Professional Development credits
- Ideal for 20-30 employees
- Intended for actuaries of any level
- At \$500, it is an excellent value

The **Professionalism Ready-to-Go Kit** aims to increase awareness of potential professionalism issues and resources available for solving them, which will lead to a better understanding of the Code of Professional Conduct.

Learn more at www.soa.org/ReadyToGoKit.
Contact Sherri Blyth at sblyth@soa.org with questions.



FACTS ABOUT THE FIRST EDITION OF TAXING TIMES

- Length of the newsletter: 20 pages
- Lead article: “*Evolution of the Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code*,” by Christian DesRochers
- “Name the Newsletter” Contest: Gary Pauline was the winner, drawn from multiple entrants who came up with “*TAXING TIMES*”
- *TAXING TIMES* editorial staff:
 - Brian G. King, Editor
 - Christine Del Vaglio, Editorial Assistant
 - Editorial board members: Peter H. Winslow, Bruce D. Schobel and Ernie Achtien

Varied Perspectives. Life insurance company and policyholder tax issues typically require insight from multiple disciplines, not just actuarial. From the beginning, the Taxation Section was very intentionally a cross-disciplinary group, welcoming affiliate members from the legal and accounting professions along with SOA members. Many of these affiliates have been active participants and leaders in the objectives of the section, particularly in its goal to provide valuable and timely continuing professional education. The creators of *TAXING TIMES* made a commitment to seek input and involvement from attorneys, accountants, actuaries and other tax professionals in deciding on and developing the content for each issue. This has been a defining aspect of the section and the newsletter, and it crystallized in the development of interdisciplinary dialogues covering some of the most complex issues in the insurance tax space—principle-based reserves for life insurance and for variable annuities, developments in International Financial Reporting Standards (IFRS) on accounting for insurance contracts, the definition of the statutory cap on tax reserves, and, in this issue, the concept of deference to the National Association of Insurance Commissioners (NAIC) in developing and administering tax laws relating to insurance companies.

The newsletter was designed to have something for everyone—the dialogues provide several different perspectives while exploring dense issues; there are also longer research pieces related to emerging issues affecting our industry, and shorter “*TAXING TIMES* Tidbits” that may be of interest to a narrower audience. The goal has been to provide a balance between company and policyholder tax content, and to use the newsletter not only to keep our readers informed on emerging tax issues, but also to educate readers on more basic tax matters. In pursuit of these goals, *TAXING TIMES* has been constantly evolving and introducing new features (see details below).

From time to time, the editorial board has decided to produce special editions of *TAXING TIMES* in addition to our three scheduled issues each year. These *TAXING TIMES* Supplements provide additional flexibility for dealing with substantive tax topics that may not fit well within the normal production schedule. We have used them to accommodate longer research pieces dealing with particular tax rulings, as well as to provide sufficient attention to new or emerging issues that are of particular importance to life insurance companies.



KEY DEVELOPMENTS IN THE HISTORY OF TAXING TIMES

- February 2007: The first of many interdisciplinary dialogues: “Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM”
- February 2008: The “ACLI Update” column is introduced as a way to keep our readers informed on the tax-related activities and issues facing the ACLI
- May 2008: The first of a series of interviews with key participants in the insurance tax environment, Walter Welsh, ACLI
- September 2008: The first *TAXING TIMES* Supplement
- May 2009: A fresh new look as the newsletter entered its fifth year—also, the first issue to exceed 50 pages
- February 2013: The current record for the longest issue of *TAXING TIMES*, at 68 pages
- October 2013: Peter Winslow introduces a new column within “T3: *TAXING TIMES* Tidbits,” called “Subchapter L: Can You Believe It?” exploring the many quirks of life insurance taxation
- May 2014: “In the Beginning ... A Column Devoted to Tax Basics” is introduced as part of the section’s outreach to newer or younger members

Important Industry Role Played by *TAXING TIMES*.

In its first decade of existence, the newsletter has become a critical part of life insurance tax discourse. One of our highlights for facilitating cooperation and understanding is the work of the 2001 CSO Maturity Age Task Force, published in *TAXING TIMES* in May 2006. This task force was formed by the SOA Taxation Section in response to the adoption of the first life insurance mortality tables extending beyond the “deemed” maturity ages of 95 to 100 built into IRC sections 7702 and 7702A. The task force developed and recommended a series of computational rules to establish an actuarially sound approach to compliance with the requirements of IRC sections 7702 and 7702A for contracts having actual maturity dates after age 100. Following our publication of the task force’s recommendations, the IRS and Treasury engaged with the proposed approaches, largely adopting them as a safe harbor in Rev. Proc. 2010-28 (and citing *TAXING TIMES* in the guidance itself!).

The editors of *TAXING TIMES* recognize that individuals in the government read our publication and rely on it as a source of information to assist in their analysis and understanding of complex insurance tax issues. As we stand on the verge of principle-based reserves (PBR) for life insurance products, we

TAXING TIMES SUPPLEMENTS

- September 2008: “Fortuity, Or Not Fortuity? ... That Is The Question” (by Frederic J. Gelfond, on Rev. Rul. 2007-47 and the definition of insurance)
- February 2009: On Revenue Procedures 2008-38 to 2008-42 overhauling the remediation process for policyholder tax compliance issues (many contributors)
- February 2010: “Actuarial Guideline XLIII: Statutory and Tax Issues” (by Edward L. Robbins and Richard N. Bush, on newly adopted reserving requirements for variable annuities)
- May 2012: On what constitutes a “material change” to a life insurance contract and considerations for administering the various eras of product qualification rules (by John T. Adney and Craig R. Springfield, and Christian DesRochers and Brian G. King)
- October 2014: On the tax reform discussion draft issued by House Ways and Means Committee Chairman Dave Camp (R-MI) in February 2014 (lead article by Brion D. Graber and Peter H. Winslow, with many other contributors)

“During my tenure at both IRS and Treasury, each new issue of *TAXING TIMES* was read consistently and carefully. We never viewed any *TAXING TIMES* article as a “gotcha,” so much as a place to identify emerging issues and understand legitimate, competing arguments. The Age 100 Safe Harbor revenue procedure¹ had its genesis in the *TAXING TIMES* summary of the 2001 CSO Maturity Age Task Force recommendations in 2006.² In fact, that summary was called out not once, but twice, in the IRS Cumulative Bulletin. The quality of the thought pieces and stature of the contributors was very highly regarded.”

Mark S. Smith, former attorney-advisor in the Treasury Department Office of Tax Policy, former chief of the Insurance Branch in the IRS Chief Counsel’s Office, and current editorial board member

“As an original member of the *TAXING TIMES* Editorial Board, I am very proud of what we accomplished. In an amazingly short period of time, *TAXING TIMES* became the preeminent source for critical analysis and practical guidance on tax issues of concern to life insurance companies and their customers. It truly has been a team effort of the editorial board, SOA staff, volunteer authors and peer reviewers. But, one person’s vision and hard work is most responsible for launching, and then ensuring the quality of, *TAXING TIMES* during the formative years. Without the dedication of Brian King, I do not think *TAXING TIMES* would be what it is today. Thank you, Brian.”

Peter H. Winslow, founding editorial board member and regular contributor



can call again on the section and *TAXING TIMES* to educate and assist both our members and the government as they address the critical issues that arise from PBR.

The Publication Process. While we strive for timeliness with the production schedule, we are occasionally challenged to provide timely content to our readers. We have implemented a rigorous peer review process that all articles must go through, including approvals for every topic presented in each issue. From time to time, the discussions become somewhat spirited and the commentary is quite frank on whether a particular topic is appropriate for *TAXING TIMES* or whether an article is drafted to meet our quality standards from both a technical and a grammatical/stylistic perspective. Unfortunately, the rigor of our editorial process takes time, and taking into consideration the Society of Actuaries publication process as well, turning around timely content to our readers becomes challenging. Nonetheless, we are constantly challenging SOA staff on the importance of last-minute updates and needing to add post-production commentary to articles when critical guidance emerges in the midst of our production schedule that is of particular relevance to an article. Their willingness to work with the editorial team is very much appreciated, and we know we have tried their patience from time to time. Recognizing that the average page count of *TAXING TIMES* is well over twice the page count of the average SOA section newsletter (and for some issues, three to four times the average length), we know we have pushed the envelope, with page counts exceeding a newsletter’s capacity to properly fit into an envelope, having to use a lighter stock paper for larger issues so it will properly

staple, last-minute additions for emerging guidance after the issue has gone to layout, etc. We truly appreciate the help and support that Kathryn Baker, Jacque Kirkwood and their colleagues have provided over the years.

Many Hands Make Light Work. In addition to the SOA staff, there are many volunteers involved in the production of each newsletter, and the cast is continually changing as we seek to bring new individuals and perspectives to the conversation. We would like to recognize and thank those who have served on the Taxing Times editorial team during the first decade, including the following professionals (listed alphabetically):

Ernie Achtien
John T. Adney
Mary Elizabeth Caramagno
Christian J. DesRochers
Sheryl Flum
Frederic J. Gelfond
Brian G. King
Samuel A. Mitchell
Kristin Norberg
Kory J. Olsen
Arthur Schneider
Bruce D. Schobel
Mark S. Smith
Gregory Stephenson
Daniel Stringham
Peter H. Winslow

Many of the editors have also been among our most prolific authors; we thank them and all of the other past and current contributors of the high-quality content of *TAXING TIMES*.

"I credit *TAXING TIMES* with helping me to understand the tax aspects of some complex actuarial concepts both when I was chief of the Insurance Branch at IRS and now. For example, the articles about AG 43 and earlier actuarial reserve methods for variable annuities were very helpful in crafting guidance (Notice 2010-29) and in understanding how company experience is an important criteria for setting reserves. The articles always explain technically dense issues in a way a non-actuary can comprehend without over-simplification. An amazing feat! I eagerly read every issue cover-to-cover and look forward to getting the next issue. Congratulations to the SOA Taxation Section for putting out such an impressive newsletter."

Sheryl Flum, former chief of the Insurance Branch in the IRS Chief Counsel's Office, and current editorial board member

Brian G. King is an executive director at Ernst & Young LLP and may be reached at brian.king3@ey.com.

Kristin Norberg is a manager, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at kristin.norberg@ey.com.

Excerpt from the first “From the Chair” column, in the May 2005 issue of TAXING TIMES:

“We need to nurture an environment where taxation is a major professional actuarial field and further an attractive career path for a young actuary. Knowledgeable tax actuaries who can work well with attorneys and accountants both inside and outside their organizations can enjoy rewarding careers. It is one of our primary mission objectives [as a nascent Taxation Section] to encourage the development of strong leaders in this field.”

Edward L. Robbins, first chairperson of the Taxation Section Council, and frequent contributor to TAXING TIMES in the years since

Remembering those who helped pave the way. We would be remiss if we did not acknowledge the passing of two of our dear friends who played important roles in the development of the newsletter. The *TAXING TIMES* family lost two of our own, Chris DesRochers in 2013 and Christine Del Vaglio in 2012. Chris and Christine were involved with Taxing Times from its start in 2005, helping shape the design, structure, content and editorial process for the newsletter. We are thankful for their contributions and miss them dearly.

Into the Future. Ten years into the life of *TAXING TIMES*, we stand at a potentially historic moment in the insurance tax world. Reserving approaches are being revolutionized to account for the complex nature of the underlying risks in today’s insurance products. Product developments, including hybrid products to meet the needs of an advancing and sophisticated population of Baby Boomers, present complications in fitting into the existing structure of both policyholder tax compliance and insurance company tax. Comprehensive tax reform is a real possibility, with discussion drafts of potential statutory language in circulation, and insurance provisions included in U.S. federal budget proposals each year. Globalization is a continuing force, with tax authorities aiming to maintain control and information flow through FATCA, BEPS, and similar endeavors. Meanwhile, many of the “old guard” of tax actuarial pioneers have retired or are nearing retirement, and we are reminded of Ed Robbins’ call to action as the first Chairperson of the Taxation Section Council (see quote), to foster and develop new leaders in the field to carry on this important work. It’s an exciting time to be a tax actuary, and we look forward to the next decade of *TAXING TIMES*! ◀

END NOTES

- ¹ Note: The Court’s opinion was released on June 25, 2015, at 576 U.S. ____ (2015), ruling in favor of the government in administering subsidies to individuals who purchase insurance on federally-sponsored health exchanges in states that did not establish their own exchanges.

IN THE BEGINNING...

A COLUMN DEVOTED TO TAX BASICS



CONSEQUENCES OF INSURANCE BUSINESS OR COMPANY ACQUISITIONS

By Gary R. Vogel and Kristie Khaw¹

Editor's Note: The objective of this "In the Beginning ..." piece is to provide some explanatory background, including a helpful numerical example, regarding the primary tax provisions that are the subject of Chief Counsel's Advice (CCA) 201501011 (Sept. 4, 2014). The CCA is also discussed in this edition's "TAXING TIMES Tidbits," in "IRS Concludes in CCA that Section 197 Applies to All Section 1060 Indemnity Reinsurance Transactions" by Lori J. Jones, page 43.

A buyer wanting to purchase a business can generally do so by purchasing either stock of a target company (Target) from its shareholder or the assets of the Target directly from the Target. The difference between these acquisition alternatives from a federal income tax standpoint is whether the buyer will have a fair market value basis in the stock of the Target or in the assets of the Target, since it only receives a fair market value basis for tax purposes in what it purchases. The amount of basis a buyer has in its assets is important, since the basis, along with the amount received on a subsequent sale of the assets, will impact the amount of taxable gain or loss on such subsequent sale.

To illustrate this point, assume that a buyer pays \$10 to acquire the assets of a Target and that the Target has an \$8 tax basis in its assets. If the buyer acquires the Target's stock, the buyer will be entitled to a tax basis in the Target's assets of \$8. If the buyer instead acquired the Target's assets directly, it would be entitled to a \$10 basis in the assets. If the buyer were to subsequently sell the Target's assets for the same \$10 amount it paid, the buyer would be required to recognize a \$2 taxable gain if it had purchased the Target's stock. If it had acquired the assets directly, it would not have had to recognize any taxable gain on the subsequent sale of the assets.

From the seller's perspective, the amount of gain or loss it would recognize in a sale of stock is not necessarily equivalent

to the amount of gain or loss that the Target would recognize in an asset sale. This is because the amount of such gain or loss depends on the seller's basis in the Target's shares and the Target's basis in its assets, which are often different amounts in the aggregate. Following the example above, if the purchase price is \$10, the seller has a \$5 tax basis in the Target's stock, and the Target has an \$8 tax basis in its assets, a stock sale would generate a \$5 gain while an asset sale would generate only a \$2 gain.²

SECTION 338 AND 1060 TRANSACTIONS GENERALLY

If certain requirements are met, the buyer and seller may be able to elect to treat what is in form a stock purchase as an asset purchase for federal income tax purposes. This can benefit one or both of the parties by eliminating any stock gain and providing both the buyer with a fair market value in the Target's stock and the Target with a fair market value basis in its assets. Specifically, a buyer may purchase the stock of a company and elect under section 338³ to treat the stock purchase as a hypothetical asset purchase between an "old" Target and a fictional "new" Target followed by a deemed liquidation of the "old" Target.⁴ Where a section 338 election is made, a residual allocation approach is applied to determine the amount of gain to be recognized and the Target's resulting basis in its assets. In this regard, the seller's aggregate deemed sales price (ADSP) and the purchaser's adjusted grossed-up basis (AGUB) (generally the amount paid for the Target's shares plus the Target's liabilities) are allocated among the transferred assets using a tiered approach that is generally referred to as a "residual allocation" methodology.⁵ Pursuant to section 1060, this methodology also applies to asset acquisitions in which goodwill or going concern value could attach to the acquired assets. This is normally the case where customer lists or relationships or a workforce in place is acquired as part of an asset acquisition. The residual allocation methodology utilizes seven classes, beginning with cash (Class I) and ending with what are referred to as section 197 intangibles (Class VI) and a residual category called "goodwill and going concern value" (Class

CONTINUED ON PAGE 12

Gary R. Vogel is an executive director in the Transaction Tax practice with Ernst & Young LLP and may be reached at gary.vogel@ey.com.

Kristie Khaw is a tax senior in the Transaction Tax practice with Ernst & Young LLP and may be reached at kristie.khaw@ey.com.

VII). The classes to which ADSP and AGUB are allocated are significant because they impact the amount and character of the gain or loss recognized in the sale and the Target's future amortization of that basis in the buyer's hands. For example, section 197 intangibles are generally subject to a uniform 15-year amortization period while amortizable property in other classes may be subject to a shorter or longer amortization period.

SECTION 338 AND 1060 TRANSACTIONS IN THE INSURANCE CONTEXT

Unlike the purchase and sale of a non-insurance company, if the stock of an insurance company is purchased in a transaction for which the buyer and seller are eligible to make a section 338 election and such election is made, it gives rise to a fictional asset sale as well as a fictional assumption reinsurance transaction⁶ between the old Target and a new Target, followed by a deemed liquidation of the old Target into its selling shareholder.⁷ This is different from non-insurance company acquisitions because insurance companies have current and future obligations under insurance policies that must be transferred in what is referred to as a reinsurance transaction. A reinsurance transaction itself gives rise to tax consequences that are not present in the case of a normal asset sale.

Pursuant to regulations issued under section 338, the old Target in the fictional assumption reinsurance transaction is deemed to pay a gross amount of premium equal to the amount of the old Target's tax reserves⁸ for the acquired insurance contracts and is also deemed to receive a ceding commission in an amount equal to any portion of the ADSP allocated to the acquired contracts under the residual allocation method described in the regulations under section 338.⁹

The direct acquisition of an insurance business, whether through assumption or indemnity reinsurance, is governed by section 1060 of the Code if significant business assets are acquired to which goodwill or going concern value could attach.¹⁰ The significance of section 1060 applying to such a direct acquisition of an insurance business is that it gives rise to US federal income tax consequences similar to a stock purchase accompanied by a section 338 election, as described and illustrated above.

Consistent with a normal section 338 or section 1060 transaction, the seller (i.e., old Target) allocates the ADSP and the buyer (i.e., new Target) allocates the AGUB among the trans-

ferred assets under the residual allocation method.¹¹ However, special rules apply to the actual or deemed assumption reinsurance transaction that occurs in a section 338 or 1060 transaction. In this regard, the value of insurance contracts is a Class VI asset of the seller, and consideration allocated to such contracts is treated as a deemed ceding commission paid from the buyer to the seller.¹² Under the section 338 regulations, the fair market value of insurance contracts is "the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts."¹³

There also are significant consequences to both the seller and buyer under sections 848 and 197 regarding deductions and capitalization of certain amounts. In this regard, life insurance companies must capitalize and amortize certain amounts of "specified policy acquisition expenses," or so-called deferred acquisition costs ("DAC") under section 848(c). DAC amounts are "intended as a proxy for an insurance company's actual cost of acquiring insurance contracts"¹⁴ by serving as a "measure of the expenses incurred by an insurance company in connection with specified insurance contracts which should be capitalized."¹⁵ Section 848 requires capitalization and amortization of such expenses because the expenses are allocable to the full lives of the acquired insurance contracts, but relies on a proxy system because implementing a system that accurately capitalizes and amortizes actual policy acquisition costs would be difficult to administer and enforce.¹⁶ Generally under section 848, the amount capitalized and amortized is a specified percentage of the "net premiums" attributable to different categories of insurance contracts.

Section 197 also requires capitalization of the ceding commission, to the extent it exceeds the amount subject to DAC, paid for insurance in force (a customer-based intangible) deemed paid in a deemed assumption reinsurance transaction arising in a section 338 transaction or paid in an actual assumption reinsurance transaction effected in a section 1060 transaction. The amortization regimes of section 848 and section 197 are coordinated to the extent that reinsured contracts are subject to section 848. Generally, section 197 provides a 15-year amortization regime for "section 197 intangibles."¹⁷ If the reinsured contracts are subject to section 848, the excess of the amount of the AGUB allocated to section 197 over the amount required to be capitalized as DAC under section 848 remains

capitalized under section 197.¹⁸ The DAC amount required to be capitalized is subject to a 10-year amortization regime and the remaining portion of the amount paid is subject to the 15-year amortization regime under section 197. If the reinsured contracts are not a type of policy specified in section 848(c), then the entire amount of AGUB allocated to those contracts would be subject to capitalization under section 197.

EXAMPLE¹⁹

T is an insurance company that P purchased for \$16. T has Class IV assets (inventory) with total fair market value of \$50, individual life insurance contracts worth \$17, liabilities (tax reserves) of \$50, and \$20 of general deductions in the year of the stock sale. P made a section 338(h)(10) election.

The section 338(h)(10) election results in a deemed sale of the assets of old T to new T. As a result of the deemed sale, there is an assumption reinsurance transaction between old T and new T.

The ADSP and AGUB is \$66 (the \$16 price of the stock plus the \$50 of tax reserves). \$50 of the ADSP and AGUB is allocated under the residual method to Class IV assets (since the Class IV assets have a total fair market value of \$50), and the remaining \$16 is allocated to Class VI (which includes the value of insurance contracts).

The \$16 allocated to Class VI is treated as a deemed ceding commission. New T is deemed to receive a gross amount of premium equal to the amount of old T's tax reserves (\$50) for the insurance contracts and is deemed to pay a \$16 ceding commission for the insurance contracts. Thus, new T's net positive consideration for the insurance contracts is \$34. Because the insurance contracts are life insurance contracts, new T is subject to the DAC rules under section 848.

To calculate the DAC amount, the specified 7.7 percent is multiplied by the net positive consideration (representing the net premium amount in the context of a deemed reinsurance transaction) of \$34 for a DAC amount of \$2.62. Because the DAC capitalization amount of \$2.62 is less than the general deductions for the year of \$20, \$2.62 of the \$16 ceding commission is amortized under section 848 (10-year period) and the remaining \$13.38 of the \$16 ceding commission is amortized under section 197 (15-year period).



CEDING COMMISSION

The treatment of a ceding commission, however, has been the subject of controversy. That is, the Internal Revenue Service (IRS) has previously acknowledged that the Code and regulations treat the ceding commission as immediately deductible when assets are acquired in a section 1060 transaction involving an indemnity, rather than an assumption reinsurance transaction. A recent release from the IRS indicates a different position on the part of the IRS; i.e., that the ceding commission must be capitalized and amortized in all cases.²⁰ It is likely that there will be further public dialogue on this issue.

CONCLUSION

There are many considerations to take into account when purchasing an insurance company. In addition to the general tax consequences that arise from the acquisition of a company, the insurance-specific provisions provide an additional layer of complexity while maintaining the flexibility for a buyer to choose whether to purchase the stock or assets of an insurance company. ◀

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

END NOTES

- ¹ The authors wish to thank Frederic J. (Rick) Gelfond for his insights and comments.
- ² In addition, loss carryforwards and other tax attributes are not always equally available to the Target and its shareholder and can, therefore, impact the amount of tax liability generated by a stock versus asset sale.
- ³ All section references herein are to the Internal Revenue Code of 1986, as amended (the Code).
- ⁴ Section 338 provides for two types of elections, described in section 338(h)(10) and section 338(g). Both elections require that a corporate buyer purchases at least 80 percent of the total voting power and value of the target corporation. A section 338(h)(10) election is often more advantageous because it recharacterizes a stock purchase as an asset purchase for tax purposes, whereas a section 338(g) election gives rise to a fictional asset sale following the actual stock purchase such that any stock gain and asset gain are both recognized. However, a section 338(h)(10) election is limited to transactions where the target corporation is either a member of the same affiliated group (within the meaning of section 1504) as the seller or is an S corporation. A section 338(h)(10) election also requires a joint election to be made by the buyer and seller, whereas a section 338(g) election is made unilaterally by the buyer. Unlike other contexts where the seller has the ability to sell an entity and treat it as an asset sale outside of section 338, such as converting the target entity to a limited liability company, insurance companies are *per se* corporations that cannot be disregarded for federal tax purposes.
- ⁵ Treas. Reg. §1.338-6.
- ⁶ "Assumption reinsurance" is a type of reinsurance pursuant to which the reinsurer is substituted for the reinsured company (also referred to as the ceding insurer) and becomes directly liable for policy claims. This generally requires a notice and release from affected policyholders. In the more common indemnity reinsurance transactions, the reinsurer has an obligation to indemnify the ceding insurer, which remains liable for claims on policies it has issued, and policyholder approval is not required.
- ⁷ Treas. Reg. §1.338-11(c). For additional analysis of the regulations under §338, see J. Howard Stecker, Gregory L. Stephenson, and Frederic J. Gelfond, "ASSUMPTION: A Single Sentence Undermines Many Principles for Taxing Insurers on 'Non-reinsurance' Acquisitions," *The Insurance Tax Review* (Sept. 2000), 19 *Ins. Tax Rev.* 375 (2000); and Gregory L. Stephenson, J. Howard Stecker, and Frederic J. Gelfond, "Mapping the Code: FSA 200144028 Successfully Orders Subchapter L and Tax Provisions of General Applicability," *The Insurance Tax Review* (January 2002), 22 *Ins. Tax Rev.* 47. These regulations have also been the subject of two previous *Taxing Times* articles: Mark H. Kovey and Lori J. Jones, "Highlights of the Recent Guidance on Insurance Company Acquisitions," 9 *Taxing Times*, Vol. 2, Issue 2 (September 2006), and Lori Jones, "A Practical Guide for Determining Whether a Section 338(h)(10) Election Should Be Made for a Target Insurance Company," 25 *Taxing Times*, Vol. 5, Issue 1 (February 2009).
- ⁸ Generally speaking, tax reserves are actuarially determined estimates of an insurer's future obligations under the insurance policies that it has issued and/or assumed, subject to discounting and other adjustments that apply for US federal income tax purposes.
- ⁹ Treas. Reg. §1.338-6.
- ¹⁰ Treas. Reg. §1.1060-1(b)(9).
- ¹¹ Treas. Reg. §1.338-6 and Treas. Reg. §1.1060-1(a)(1). The ADSP and AGUB include liabilities transferred, which include the old Target's closing tax reserves (which are treated as a fixed liability in computing ADSP and AGUB).
- ¹² Treas. Reg. §1.338-11(b)(2).
- ¹³ Treas. Reg. §1.338-11(b)(2).
- ¹⁴ 67 FR 10640, 10644 (Mar. 8, 2002); 2002-12 IRB 651, 655.
- ¹⁵ ILM 20022006 (Feb. 5, 2002).
- ¹⁶ See *id.*
- ¹⁷ Section 197 intangibles include goodwill, going concern value, and intellectual property. See section 197(d).
- ¹⁸ The ceding commission paid in an indemnity reinsurance transaction is not treated as basis in a section 197 intangible, whereas the ceding commission paid in an assumption reinsurance transaction, whether actual or deemed as part of a section 338 transaction, is treated as basis in a section 197 intangible. See section 197(f)(5). See also H. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. (1993), 675, fn. 25.
- ¹⁹ See Treas. Reg. §1.338-11(c)(4), Example 1.
- ²⁰ See CCA 201501011 (Sept. 4, 2014). See also Lori J. Jones, "IRS Concludes in CCA that Section 197 Applies to All Section 1060 Indemnity Reinsurance Transactions," on page 43 of this issue.

PRIVATE LETTER RULING ON SECTION 807(f) REFINES CHANGE-IN- BASIS RULE

By Craig Pichette and Sheryl Flum



SUMMARY

In a recent private letter ruling LTR 201511013 (PLR), the Internal Revenue Service (IRS) concluded that the section 807(f) change-in-basis rule applied where certain life insurance contracts were treated as being reinsured when they actually were not, which had resulted in the life insurance reserves for the contracts being recorded in the wrong legal entity. The PLR represents the first guidance on reserve changes since Revenue Ruling 94-74. Revenue Ruling 94-74¹ addressed many of the issues presented by section 807(f),² primarily relating to whether changes to items prescribed by statute were “changes in basis” or “errors.” However, certain issues persisted. By narrowing the category of what the IRS considers to be errors, the PLR expands the universe of reserve adjustments considered to be accounting method changes to which the change-in-basis rule potentially applies. The PLR speaks to a few of these important issues and provides some analytical clarity as to how the IRS approaches them.

This article looks at the facts of the PLR, the statutory and administrative background for life insurance reserves and accounting method changes, the difference between errors and changes in basis, and the issues both resolved and raised by the PLR.

BACKGROUND OF THE RULING

The Life Insurance Contracts and Erroneous Reinsurance Treatment

In the PLR, a U.S. branch of a non-U.S. life insurance company (IC 1) entered into reinsurance agreements under which IC 1 assumed risks on both whole life and term life insurance contracts from unrelated third party insurers. IC 1 then entered into a reinsurance treaty with another insurance company (IC 2), which was related to IC 1 through common ownership. IC 1 retroceded 100 percent of the risk on the *term* life insurance policies to IC 2; IC 1 retained the risk on the *whole* life insurance policies. IC 1 had two systems for accounting for all of the insurance contracts on a contract-by-contract basis. First, it had an administrative system to track premiums, benefits payments, and other accounting items. Second, it had a valu-

ation system specifically to calculate life insurance reserves. IC 1 and IC 2 used the information from these two systems to prepare financial statements, including statutory financial statements prepared under accounting rules prescribed by the National Association of Insurance Commissioners (NAIC), which were then used in preparing IC 1’s and IC 2’s U.S. federal income tax returns.

Several years after entering into the reinsurance agreement, IC 1 and IC 2 reviewed the valuation system’s coding of the life insurance contracts as either whole life or term life. They discovered that, in the valuation system, some whole life insurance contracts (on which IC 1 had intended to retain the risk) had been labelled as term life insurance contracts. Consequently the valuation system reported the life insurance reserves for these contracts as reserves of IC 2 rather than of IC 1. All of the relevant accounting items other than reserves were maintained in the administrative system and were reported on the appropriate legal entity. IC 1 and IC 2 corrected their statutory annual statements and reported the life insurance reserves on the appropriate legal entity in the year the error was discovered (Tax Year U). There is no assertion in the ruling that the amount of the life insurance reserves determined under sections 807(d)(1) and 807(d)(2) was incorrect; the reserves were simply reported on the wrong legal entity.

Tax Effects of Recording Reserves in the Wrong Entity

IC 1 reported premium income attributable to the identified whole life insurance contracts under section 803(a)(1)(A). It did not reduce its premium income for any amounts paid to IC 2 for reinsurance under section 803(a)(1)(B) because these contracts were not ceded to IC 2. However, IC 1 decreased its life insurance reserves for the mislabeled contracts because, according to the valuation system, these contracts had been reinsured to IC 2. Thus, IC 1 understated its deduction allowed under section 807(d)(1), which in turn overstated its taxable income.

CONTINUED ON PAGE 16

Similarly, IC 2 did not report reinsurance premium income under section 803(a)(1)(A) because the contracts were not assumed by IC 2. However, IC 2 increased its life insurance reserves for the mislabeled contracts because they were treated as reinsured by the valuation system. This increase in reserves understated IC 2's taxable income.

The misstatements of income by IC 1 and IC 2 would reverse over time. The administrative system would properly treat the death benefits, claims, losses, and surrender proceeds as accounting items on the financial statements and tax returns of IC 1. The valuation system would reduce the reserves on the financial statements and tax returns of IC 2 when the benefits were paid. Thus, the misstatement of income by each entity would naturally reverse over the durations of the underlying insurance contracts.

The IRS's conclusion

The IRS concluded that the changes in life insurance reserves by IC 1 and IC 2 for Tax Year U were changes in basis subject to section 807(f). Tax Year U was treated as the year of change. The opening reserves of IC 1 and IC 2 were adjusted as of the beginning of the following taxable year (Tax Year V) with one-tenth of adjustment to be recognized in each of the ten succeeding tax years.

LEGAL CONTEXT

Section 446-Basic Rules for Changes in Accounting Methods

Treasury Regulation section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any "material item." A material item is "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, the critical question is whether the accounting practice permanently affects the taxpayer's lifetime income, in which case it is not a material item, or merely changes the taxable year in which taxable income is reported, in which case it is a material item.³

Generally, consistent treatment of an item establishes a method of accounting. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns constitutes consistent

treatment of that item sufficient to establish a method of accounting.

Treasury Regulation section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not occur when a taxpayer seeks to correct a *mathematical error*, a *posting error*, or an error in the *computation of tax liability*. The IRS has interpreted this regulation to require that *systematic* posting errors—errors that are repeated over at least two years and that affect timing—be treated as methods of accounting.⁴ In both *Huffman v. Commissioner*⁵ and *Wayne Bolt & Nut Co. v. Commissioner*,⁶ the Tax Court concluded that the systematic errors at issue were methods of accounting because the error embedded at the end of one year would be picked up and offset in the next or a future year.

Section 481(a) provides that, in computing taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. An adjustment under section 481(a) can include amounts attributable to taxable years that are closed by the applicable statute of limitations.⁷

Section 807 (a brief history) and Revenue Ruling 94-74

Section 807(a) and (b) provide that increases in a life insurance company's reserves are deducted from the company's gross income, and decreases in reserves are includible in its gross income. Section 807(c) sets forth the items to be taken into account by a life insurance company in determining whether it has an increase or decrease in reserves for purposes of sections 807(a) and (b). The specified items in section 807(c) include life insurance reserves. Section 807(d)(2) prescribes the U.S. federal income tax rules for computing a company's life insurance reserves, including the reserve methods, interest rates, and mortality tables to be used in these computations.

Section 807(f) provides that if the basis for determining any item referred to in section 807(c) as of the close of any taxable year differs from the basis for determining that item as of the close of the preceding taxable year, the taxpayer must spread the taxable income effects of the change ratably over

the 10 years following the year of change. A change that is subject to section 807(f) is referred to as a “change in basis.” Significantly for U.S. tax purposes, such changes are automatic and do not require the consent of the Commissioner of Internal Revenue.

The provision that is currently section 807(f) was enacted as section 810(d) by the Life Insurance Company Income Tax Act of 1959.⁸ By enacting section 810(d), Congress provided a specific tax rule for adjustments resulting from a change in method of computing reserves; such changes otherwise would have been subject to section 481 for changes in method of accounting.⁹ This special rule was intended to allow insurance companies to avoid the income distortion created by taking the entire impact of a change in basis of computing reserves into account in computing taxable income for a single taxable year.¹⁰

The 10-year ratable adjustment rule was reenacted as section 807(f) by the Tax Reform Act of 1984.¹¹ By using the same language that was used in pre-1984 Act section 810(d), Congress signaled its intent that section 807(f) be construed in accordance with prior law: “The present law allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained.”¹²

Under the rulings and case law interpreting section 807(f)’s predecessor section, a change in basis may occur whether the change in manner of computing the reserve is voluntary or involuntary, as well as where there is a change from incorrect to correct reserve computations.¹³ As indicated above, a change in basis of computing any of the items in section 807(c) is not a change in method of accounting requiring the consent of the Secretary under section 446(e).¹⁴ Accordingly, where there is a change in basis under section 807(f), the taxpayer is required to apply the more specific insurance tax accounting rules in section 807(f) rather than the general tax accounting method rules in section 446.

The IRS provided significant guidance on section 807(f) in Revenue Ruling 94-74.¹⁵ Revenue Ruling 94-74 addresses the applicability of section 807(f) to four situations in which a life insurance company makes changes to its reserves. The first situation involves a change in the mortality table used to compute the reserves; the second involves a change in the

interest rate used; the third involves a changed assumption from a curtate to continuous function; and the fourth involves a computer program error which causes certain policies to be omitted from the computation altogether. In each of the first three situations, the revenue ruling concludes that the change is a change in basis subject to section 807(f) and, thus, the 10-year spread rule applies. Situation four postulates a fact pattern where a reserve is properly computed, but because of a computer error, is not included in the sum of total reserves for the year in question. The ruling concludes the change is an error and not subject to the 10-year spread rule. The revenue ruling was significant in that it concluded that even changes in the computation of reserves for items which are mandated by statute, such as interest rates or mortality tables, are changes in basis rather than corrections of errors.

The conclusion in situation four in Rev. Rul. 94-74 is consistent with the narrow definition of an error under section 446 where an “error” of this type is not a method of accounting when it is isolated and nonrecurring. In contrast, a systematic error in the computation of taxable income that affects only the timing of lifetime taxable income and self-corrects over time is a method of accounting. In the years following the issuance of Rev. Rul. 94-74, both the Examination and Appeals divisions of LB&I (then LMSB) published Coordinated Issue Papers¹⁶ clarifying that the conclusion in situation four only applied to nonrecurring mathematical or posting errors, apparently to ensure consistency with the general accounting method rules.

Changes in Basis and Corrections of Errors

Assume that a life insurance company (L1) issues whole life insurance contracts. Assume that for all contracts issued by L1, the reserve computed under section 807(d)(2) is greater than the net surrender value and less than the statutory reserve for the contract. In 2014, L1 determines that the reserve was “improperly” computed for statutory and federal income tax purposes and was corrected on the 2014 annual statement. For simplicity, assume that no new contracts were issued in 2014. On Dec. 31, 2014, the tax reserve computed under the “old” method is \$10,000,000. The tax reserve computed on that date under the “new” method is \$12,000,000.

This change in the computation of the reserve is treated as a change in basis under section 807(f), the tax year ending Dec. 31, 2014 is the year of change, but the “old” method of

computing reserves is used to compute the tax reserve for the contracts issued prior to 2014 at Dec. 31, 2014. The opening reserve at Jan. 1, 2015 on the tax return for the year ending Dec. 31, 2015 is adjusted from \$10,000,000 to \$12,000,000 and the \$2,000,000 adjustment is spread over ten tax years beginning on the return for the year ended Dec. 31, 2015. In this case, the taxpayer “missed” deducting the \$2,000,000 in years prior to 2015, but recovers that deduction over the following ten years. The issue is purely one of timing for tax return, and, perhaps more importantly, for financial reporting purposes.

“The PLR appears to take a broad view of what changes are governed by section 807(f) as opposed to the more general accounting method change rules.”

Alternatively, assume the taxpayer finds in 2014 that it made an error in the computation of reserves for the year ending 2012 such that total reserves were reported for tax purposes as \$6,000,000, but the correct total reserve should have been \$7,000,000. Assume the error was a one-time misstatement that did not impact reserve computations for tax years 2013 and 2014. If the \$1,000,000 change is treated as the correction of an error instead of a change in basis, the taxpayer would restate its opening reserve as of January 1, 2012 on its tax return for the year

ended December 31, 2012. The opening reserve would be increased from \$6,000,000 to \$7,000,000 and the reserve at each subsequent tax year end would be recomputed under the corrected method. The net effect of this characterization is the permanent loss of \$1,000,000 of reserve deductions for tax purposes. There is no spread or recovery of the \$1,000,000 opening reserve adjustment on the 2012 tax return.

ANALYSIS OF PLR

The PLR implicates several important issues:

- How do sections 446 and 807(f) interact?
- Are changes in statutory reserves potentially subject to sections 446 or 807(f)?
- Can merely repeating a “posting” or “computer” error over multiple years create a method of accounting?

Interaction of Sections 807(f) and 446

Section 807(f) is properly viewed as a subset of accounting method changes otherwise subject to section 446. This reading of the statutory scheme was articulated in *American General Life & Accident Ins. Co. v. United States*:

There need be no conflict between section 481 and the 10-year spread rule of section 810. Code section 481 is simply a much more general provision dealing with recapture of tax income in a broad variety of cases. It is a broad rule which generally authorizes recapture. Code section 810, on the other hand, is much more specific and deals with a very narrow and limited type of “change in method of accounting.” It in no way contradicts the general rule that there should be recapture of tax loss. It simply provides a more specific manner of recapturing tax loss under one set of particular circumstances in which there was an accounting change, namely circumstances in which there was a change in the method of computing reserves. As usual, the specific controls the general. It is not a contradiction of the general rule. Accordingly, while the government is correct in classifying the change at issue as a change in method of accounting, it is also more specifically a change in the method of computing reserves.¹⁷

The same interpretation was adopted in Revenue Ruling 94-74:

Under section 446, a change in method of accounting does not include correction of mathematical or posting errors. See, e.g., section 1.446-1(e)(2)(ii)(b). Because section 807(f) is a more specific application of the general tax rules governing a change in method of accounting, a circumstance that is not a change in method of accounting under the general rules cannot be governed by the more specific rules of section 807(f). Accordingly, consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis under section 807(f).

Thus, in assessing how a particular change to the calculation of the deduction allowed by section 807(d)(1) should be implemented, a two-step analysis applies:

- Is the change a “method of accounting” or “correction of an error” under section 446?
- If it is a change in method of accounting, is it a change in basis subject to section 807(f) or is it subject to the more general accounting method change rules of section 446?

The PLR appears to take a broad view of what changes are governed by section 807(f) as opposed to the more general accounting method change rules. As indicated above, the amount of the reserve actually computed by the taxpayers under sections 807(d)(1) and (d)(2) was apparently correct. One might ask how there could be a “change in basis” where the reserve was properly computed. Alternatively, Treasury Regulation section 1.801-4(a) provides that the amount of the

reserve for a contract must be reduced by the net value of risks reinsured. This would suggest that the reserve was not, in fact, properly computed and that the correction is a change in basis. The PLR seems to adopt the second point of view.

A change under section 807(f) does not require the IRS's consent, but it also does not bring with it the audit protection provided by filing a Form 3115 under the general rules of section 446. Also, while it may generally be beneficial to taxpayers to spread income arising from a change in basis over ten years, some taxpayers (perhaps those with expiring net operating losses) would prefer to recognize the income immediately. Also, taxpayers that are realizing a deduction from a change in basis may prefer to recognize that deduction immediately instead of over a decade. Finally, 10 years is a long time—tracking multiple section 807(f) adjustments can become an administrative burden that some taxpayers may wish to avoid.

Would a Change in Method for Computing Statutory Reserves or Net Surrender Value Be Subject to Section 446 or Section 807(f)?

The PLR could provoke questions regarding whether there can be a change in basis under section 807(f) that is not also a change in method under the general method of accounting rules in section 446. This gives rise to an interesting, unanswered question as to whether, for instance, changes in the calculation of the statutory reserve or net surrender value which indirectly affect the amount of the reserve deduction allowed for a contract for federal tax purposes is a change in basis subject to section 807(f) or, if it does not represent a change in basis, whether it could be a change in method of accounting subject to section 446.

In Notice 2010-29,¹⁸ the IRS addressed an issue arising from the implementation of Actuarial Guideline 43 (AG 43) effective Dec. 31, 2009. AG 43 introduced new actuarial guidance for the calculation of reserves on a variety of annuity contracts, most significantly those with minimum guaranteed benefits. AG 43 generally had the effect of reducing statutory reserve requirements for these contracts. The IRS has taken the view that actuarial guidance does not apply for tax purposes to contracts issued prior to the effective date of the new guidance—even if the guidance is retroactively effective for statutory purposes.¹⁹ AG 43 generally resulted in lower statutory reserves than the tax reserves associated with the contracts computed under the actuarial guidance previously applicable to the contracts. Thus, upon adoption of AG 43 for statutory accounting purposes, many taxpayers had their reserve deduction reduced due to “statutory capping” in section 807(d)(1)(B).²⁰

Section 3.04 of Notice 2010-29 provides that the effect of statutory capping upon adoption of AG 43 is to be spread over 10 years. The notice refers to “the method prescribed by section 807(f)(1)(B),” although it is careful not to refer to the change as governed by section 807(f). In addition, the notice specifically states (in section 3.07) that no inference should be drawn from this treatment with respect to any other federal tax issue. The PLR does not address whether the appropriate treatment of statutory capping caused by a change in the methodology used to calculate the statutory reserve is a change in method of accounting, an error, a change in basis, or a change not governed by any of those provisions. There are two ways to approach this issue.

One approach would be to determine if a change in the treatment of a statutory reserve item constitutes a change in method of accounting. In this analysis, we must first determine if a change in statutory reserving that effects the reserve deduction qualifies as a change in method of accounting. In other words, would a change in the treatment of a statutory reserve item not permanently affect taxable income (i.e., would it involve timing) and is it recurring? This being the case, a change in statutory reserving could be seen as a change in accounting method. The next step would be to determine if a change in accounting method for statutory reserves could be a change in basis, requiring that the change in statutory reserving be spread over ten years pursuant to section 807(f), or whether the change in method would be subject to Treasury Regulation section 1.446-1(e). Taking a broad view of Notice 2010-29, notwithstanding its cautionary language, it seems that if a change in statutory reserving was seen as a change in accounting method, the IRS would consider that change to be a change in basis subject to section 807(f).

Viewed differently, changes to statutory reserve methods that impact statutory capping could be considered a change in fact, but not a change in the application of section 807(c). Under this view, a change to the statutory reserve method would not be a change in accounting method, so neither section 446 nor section 807(f) would apply.

Most practitioners have taken the view that changes in the deductible reserve caused by changes in the net surrender value of a contract or statutory reserves are not subject to section 446 or 807(f), at least when the change occurs by normal operation of the calculations over time, i.e., there is no change in the computational methodology for the net surrender value or the statutory reserve. This view is supported by language in the Report of the Joint Committee on Taxation on the Tax

Reform Act of 1984 which provides that changes in net surrender value are not subject to section 807(f).²¹ It is, however, unclear as to how broadly this language is to be read, if it is to be given any deference at all.²² Does it apply when a taxpayer corrects an improper calculation of the net surrender value, or only when the net surrender value exceeds the section 807(d)(2) reserve and, thus, determines the amount of the reserve deductible under section 807(d)(1)?

CAN A REPEATED ERROR BE A METHOD OF ACCOUNTING?

As discussed above, under Treasury Regulation section 1.446-1, if the treatment of an item is a “method of accounting,” it is treated as a method of accounting even if it is also an error. The tax accounting treatment of an item is a method of accounting if it meets two requirements: first, it must be “material,” i.e., an item affecting the timing of the recognition of income or deduction, and, second, it must be consistently applied.

Arguably, the mislabeling of the contracts that occurred in the valuation system is merely a posting error, i.e., an error in “the act of transferring an original entry to a ledger.”²³ However, IC 1 and IC 2 reported the life insurance reserves for the mislabeled contracts as reserves of IC 2 for several years, which represents the consistent treatment of an item as provided for in the regulation.

In addition, the effect of reporting the life insurance reserves as reserves of IC 2 is only a timing matter and does not affect the total amount of taxable income to be recognized by either entity over the life of the reinsurance agreement. Therefore, the item is “material” as defined in the regulation. Because the mislabeling is both material and consistently applied, it is an accounting method as defined in Treasury Regulation section 1.446-1. Further, the change is not caused by a nonrecurring mathematical or “posting” error of a permanent nature. Said another way, the type of error that caused the misreporting of life insurance reserves by IC 1 and IC 2 is not the type of “error” described in the regulation (see the discussion above on the definition of an error).

The narrow definition of an “error” would seem to be a practical approach to a difficult problem. Like many tax computations, the determination of life insurance reserves is a complicated process involving complex actuarial and accounting systems and requires a significant amount of actuarial expertise. In many cases it would be difficult, if not

impossible, to determine whether the root cause of an “error” is simply a “posting” or “mathematical” error embedded in a computer system or a mistake of judgment made by a person.

For instance, it is clear that a change from an erroneous mortality table to a correct mortality table in a reserve computation is a change in basis as defined in section 807(f),²⁴ despite the fact that the use of an incorrect mortality table can be caused by any number of factors, including but not limited to the intentional or unintentional choice by an actuary, the incorrect coding of the mortality table within the actuarial valuation system, a data transfer error within the program, or any number of other possibilities given the complexity of modern accounting and valuation systems. Since it is beneficial to the tax authorities for taxpayers to avail themselves of correction mechanisms, there should be little incentive to make inquiries as to how the error occurred. The tax effects of the correction of the mortality table are always appropriately treated as a change subject to section 807(f) regardless of the underlying root cause which may, in any case, be difficult to identify.

In the PLR, the life insurance reserves of IC 1 and IC 2 were misstated. This could be cast either as a computer error, i.e., miscoding of contracts in the system, a human error since someone made the decision to treat the contracts as reinsured when they were not, or a misapplication of the tax law because the computations of life insurance reserves were not properly increased or decreased for the net value of risks reinsured as required by section 807 and Treasury Regulation section 1.801-4(a). The narrow section 446 definition of an error is a practical and rational way to avoid attempts to distinguish between the root causes of computational issues in tax accounting.

CONCLUSION

Perhaps the most important point to be gleaned from this PLR is that, by treating the mislabeling of the life insurance reserves as not being a mere posting error, the IRS is maintaining its position that most changes to the calculations of a life insurance reserve are not errors. Revenue Ruling 94-74 included only one situation with an error, and that error was limited to a mistake made in a single year. The companies in the PLR made what arguably is a posting error, but because they consistently repeated the error, the IRS felt justified in classifying the error as a method of accounting to which section 807(f) applied. ◀

END NOTES

- ¹ 1994-2 C.B. 157.
- ² Unless otherwise specified or clear from context, "section" references are to the Internal Revenue Code of 1986, 26 U.S.C., as amended.
- ³ See Rev. Proc. 97-27, § 2.01(1), 1997-1 C.B. 680; *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 723 (1982).
- ⁴ See Rev. Rul. 77-134, 1977-1 C.B. 132; Rev. Rul. 80-190, 1980-2 C.B. 190.
- ⁵ 126 T.C. 322, 343-45, *aff'd*, 518 F.3d 357 (6th 2008).
- ⁶ 93 T.C. 500, 510-11 (1989).
- ⁷ *Graff Chevrolet Co. v. Campbell*, 343 F.2d 568, 571- 572 (5th Cir. 1965); *Rankin v. Commissioner*, 138 F.3d 1286, 1288 (9th Cir. 1998); *Superior Coach of Florida v. Commissioner*, 80 T.C. 895, 912 (1983).
- ⁸ P.L. 86-69, 73 Stat. 112, 125 (1959).
- ⁹ Rev. Rul. 94-74, *supra*.
- ¹⁰ See H.R. Rep. No. 86-34 (Feb. 13, 1959); S. Rep. No. 86-291 (May 14, 1959).
- ¹¹ P.L. 98-369, 98 Stat. 494 (the "1984 Act").
- ¹² See H.R. Rep. No. 432, at 1417; Senate Committee on Finance, Deficit Reduction Act of 1984, at 543. In general, where a provision was carried over from prior law by the 1984 Act, Congress intended the new provision to be interpreted in a manner consistent with the prior law provision. H.R. Rep. No. 432, at 1402; Senate Committee on Finance, *Deficit Reduction Act of 1984*, at 524.
- ¹³ See, e.g., *American General Life & Accident Ins. Co. v. United States*, 71A AFTR 2d 93-3319 (M.D. Tenn. 1989); Rev. Rul. 77-198, 1977-1 C.B. 190 (change from a nonactuarial method of computing reserves to a method that utilizes recognized mortality tables and assumed rates of interest is a change in basis of computing reserves).
- ¹⁴ Treas. Reg. § 1.806-4(a); Rev. Rul. 94-74, *supra*.
- ¹⁵ Rev. Rul. 94-74, *supra*.
- ¹⁶ See IRC Section 807 Basis Adjustment Change in Basis v. Correction of Error, Coordinated Issue Paper (Jan. 6, 1997).
- ¹⁷ *American General Life*, *supra*.
- ¹⁸ 2010-1 C.B. 547.
- ¹⁹ See Richard N. Bush, "IRS Rules on *American Financial*," *TAXING TIMES* vol. 6, issue 2, page 10 (Sept. 2010); Peter H. Winslow, "The Sixth Circuit gets it Right in *American Financial*-An Actuarial Guideline can Apply to Prior Contracts when the Interpretation was a Permissible Option At the Time the Contract Was Issued," *TAXING TIMES* vol. 8, issue 3, page 1 (Oct. 2012).
- ²⁰ See Peter Winslow and Christian Desrochers, "Attorney-Actuary Dialogue on Notice 2010-29," *TAXING TIMES* vol. 6, issue 2, page 23 (Sept. 2010).
- ²¹ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 604 (Dec. 31, 1984) ("1984 Act Blue Book").
- ²² JCT Blue Books are among the authorities that can be cited as "substantial authority" for purposes of defending against accuracy-related penalties in section 6662. Treas. Reg. §1.6662-4(d)(3)(iii). However, because they are not written by House or Senate tax-writing committees, tax professionals and courts sometimes debate whether Blue Books are to be considered legislative history. See, for example, John T. Adney, "Blue Book Blues: The Supreme Court Discounts the Value of the Joint Committee's Blue Books in *U.S. v. Woods*," *TAXING TIMES* vol. 10, issue 2, page 12 (May 2014).
- ²³ *Wayne Bolt & Nut Co.*, 93 T.C. at 510-511 (quoting Black's Law Dictionary 1050 (5th ed. 1979)).
- ²⁴ See Rev. Rul. 94-74, *supra*, situation 1.

Craig Pichette is a partner in the Financial Institutions and Products group of KPMG LLP's Washington National Tax practice. He can be reached at cpichette@kpmg.com.

Sheryl Flum is a managing director in the Financial Institutions and Products group of KPMG LLP's Washington National Tax practice. She can be reached at sflum@kpmg.com.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

©2015 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.



ACTUARY/ACCOUNTANT/TAX ATTORNEY DIALOGUE ON INTERNAL REVENUE CODE DEFERENCE TO THE NAIC PART I: TAX RESERVES

Peter Winslow (Moderator)

John T. Adney, Timothy Branch, Sheryl Flum, Susan Hotine,
and Mark S. Smith

Editor's Note: For our 10th anniversary year of *TAXING TIMES*, we are reviving a popular format that we have used several times over the years: a dialogue among tax professionals of various backgrounds (actuarial, legal and accounting) exploring federal income tax issues applicable to life insurance companies. This dialogue will examine the important and evolving topic of the extent to which the tax law defers to the NAIC in taxing life insurance companies. It is our most ambitious dialogue yet and will be published as a three-part series in this, and the next two editions of *TAXING TIMES*. The first part of the dialogue that follows focuses on tax reserves. The next part will continue with a discussion of product taxation, and the last in the series will be a catch-all of other life insurance tax provisions where deference to the NAIC may be relevant.

I am grateful to Peter Winslow of Scribner, Hall & Thompson, LLP, for developing the concept for this dialogue and for volunteering to serve as moderator. A core group of panelists will join Peter in this series: Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the IRS Chief Counsel's Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman, LLP. Susan, John and Peter were all active in the legislative process "in the beginning"—during the enactment of the Tax Reform Act of 1984.

Joining these impressive panelists will be two actuaries who will be familiar to *TAXING TIMES* readers. Tim Branch of Ernst & Young LLP will cover the first and third parts of the dialogue on tax reserves and other company tax issues, and Brian King of Ernst & Young LLP will join the panelists for product taxation.

We hope you enjoy these dialogues!

Peter Winslow: I am pleased to serve as a moderator of this dialogue on the general topic of deference to the NAIC in the federal income taxation of life insurance companies. This first part will focus on tax reserves. It seems to me that there are two major issues on tax reserves for our panelists to discuss. The first is the basic question of what types of liabilities are deductible on a reserve basis, and what role NAIC guidance has in answering that question. Once we determine what type of liability is deductible as a tax reserve, the second issue becomes how much is deductible. And, who gets to decide—the taxpayer, the NAIC, the state regulator, or the IRS? What I would like to do is organize our discussion into three sections. First, we can set the general rules by describing how the Tax Reform Act of 1984 dealt with tax reserves and deference to the NAIC. Then, we can move into a discussion of how the case law and IRS rulings have dealt with the deference issue since 1984. And, finally, we can speculate on where we may be heading on the NAIC deference issue in the future.

Before I turn it over to the panelists, I want to take a few minutes to set the stage on the state of the tax law before the 1984 Tax Act. Under the Life Insurance Company Income Tax Act of 1959, there were two Code sections that were most relevant on the question of what type of reserve was deductible. Former section 810(c) was much like current section 807(c) and listed the deductible tax reserves.

On the NAIC deference question, the pre-1984 law was somewhat of a mixed bag. On the one hand, the deductible reserve items could be considered terms of art used in NAIC accounting—so, to the extent Congress intended the NAIC's understanding of these terms of art to apply, there was some deference to how the NAIC characterized a particular reserve. On the other hand, the case law and IRS rulings placed a gloss on the statute to permit a deduction for only "insurance reserves," as opposed to surplus or contingency reserves.

The second relevant Code provision was former section 801(b) (similar to current section 816(b)), which prescribed computational requirements that must be met in order for an amount to be considered a deductible life insurance reserve.

Because of these computational requirements, deference to the NAIC did not apply to the classification of some reserves—at least in situations of failed life reserves. But, again, we had a mixed bag under pre-1984 law because, as a general rule, insurance reserves reported in the NAIC annual statement that flunked the computational requirements for life insurance reserves were usually still allowed as a deduction—typically reclassified for tax deduction purposes as unearned premium reserves.

Susan, how did Congress address this issue of what types of reserves are deductible under the 1984 Tax Act, and, please, focus particularly on the NAIC deference question? Before you answer, why don't you describe your role in the 1984 legislative process?

Susan Hotine: I was recruited by the staff of the Joint Committee on Taxation in the fall of 1981 from the Interpretative Division of the IRS Chief Counsel's Office, where I specialized in insurance tax issues, because Congress was expected to be taking up life insurance company tax legislation. By and large, I was the only Hill staffer who had any previous experience or familiarity with insurance accounting and tax issues.

Because so many of those working on the life insurance tax legislative project were starting from ground zero, the initial question with respect to reserves was not whether the Code should defer to the NAIC regarding what types of liabilities should be deductible on a reserve basis, but whether any liability should be deductible on a reserve basis. Treasury representatives argued very strongly that reserves should be limited to cash values; if the company did not have a cash surrender liability, the company should not recognize any reserve. So, I would say that, initially, the Hill staffers working on the project were not thinking of NAIC accounting or NAIC reserve requirements at all.

In the end, the items listed as deductible reserves under the 1984 Act were based on those that had been deductible under prior law, with some modifications regarding how they should be computed. There are the prescribed computation rules in section 807(d) for life insurance reserves, but then there were the requirements that section 807(c)(3) reserves be discounted at the appropriate rate of interest (i.e., the interest rate prescribed in section 807(d)(4)) and that special contingency reserves be "reasonable." Because the section 807(c) items are pretty much the same as they were under prior law, I would say that it was assumed that regulations and guidance under

prior law would continue to be applicable. Although common industry understanding of what liabilities are referenced or included in the section 807(c) items would be relevant, at the same time the descriptive language used in the Code for the item might be used to determine what could be included therein. For example, the legislative history discussing the consequences of an annuity contract having less than permanent purchase rate guarantees explains that an increase in the fund for such contract will be treated as an increase in a reserve item under section 807(c)(3) or (4), presumably depending on whether the fund is discounted from a specific maturity value or is an accumulation fund.¹

Peter: So, what I am hearing is that Treasury's view was not adopted and the drafters of the 1984 Act decided to just carry over the pre-1984 law on the types of liabilities that get reserve treatment – which I described as a mixed bag on the NAIC deference issue.

Susan: While I do not think that the drafters of the 1984 Act were thinking about deference to the NAIC generally with respect to the types of reserves eligible for reserve treatment, I do agree that by carrying over the reserve items from prior law, some prior law deference also might be carried over (to the extent not inconsistent with guidance issued under prior law or some change adopted by the 1984 Act).

Peter: Mark, it seems Susan and I agree that Congress intended to carry over pre-1984 law for the types of liabilities that get tax reserve treatment, yet a new phrase was added in section 807(c)(1) that identifies deductible life insurance reserves by a cross-reference to the computational requirements in section 816(b). Does this mean that Susan and I have gotten it wrong—Congress in fact changed the law to clarify that failed life insurance reserves are not deductible?

Mark Smith: I wouldn't say you and Susan have it wrong, but at the same time I don't think the question itself is that simple. That is because some amounts may be deductible by a life insurance company even if they do not represent life insurance reserves under section 807(c)(1). Section 807(c)(2) through (6) lists several categories of reserves that are deductible even though they are not life insurance reserves. Those categories include unearned premium reserves, amounts necessary to satisfy obligations under insurance contracts that do not involve life contingencies, special contingency reserves, and so on. True, the amount of the reserves is not computed in the

CONTINUED ON PAGE 24

same way one would compute life insurance reserves, but falling into one of those categories doesn't mean there is no reserve deduction at all.

Also, one element of the definition of life insurance reserves is that they be set aside to liquidate claims under life insurance, endowment or annuity contracts. Section 7702(g)—also added by the 1984 Act—includes a special rule that treats a failed life insurance contract as an “insurance contract” even if it's not a life insurance contract. This rule means that the issuer of failed life insurance contracts may still qualify as an insurance company, and reserves may still be deductible as reserves even if not as life insurance reserves.

It's worth pointing out that the 1984 Act Blue Book says that the reason for the cross-reference to section 816(a) is “merely to identify the type of reserve for which increases and decreases should be taken into account.”² It does not superimpose a requirement of proper computation of state law reserves, nor does it provide license for the IRS or companies to bifurcate life insurance reserves between components that qualify and components that do not meet section 816(a)'s computational requirements for life insurance reserves. But here, I may be jumping ahead.

Peter: Now that we have set the stage for what types of reserves are deductible under the current law, let's jump ahead, as Mark says, and turn to the question of how much is deductible. On this issue I think there was quite a bit of deference to the NAIC under pre-1984 law. The Supreme Court held in *Standard Life*³ that former section 818(a) required deference to established NAIC accounting procedures in calculating tax reserves. Specifically, the Court said that because accrual accounting is not controlling for life insurance reserves, “the statute requires use of the NAIC approach to fill the gap.”

John, because you were heavily involved in the legislative process in 1984, can you share your insights on how Congress dealt in the 1984 Act with the issue of the deductible amount of reserves and the NAIC deference question?

John T. Adney: With regard to life insurance reserves within the meaning of section 807(c)(1), in 1984 Congress resolved to allow a deduction but to limit it, generally speaking, based on the minimum amount of reserves required under state law. Under prior law, the reserve deduction had been determined with reference to the reserves that an insurance company

reported on its statutory annual statement, with a formulaic increase allowed for preliminary term reserves in order for the deduction to approximate net level reserves (under former section 818(c)), with the objective of providing all companies a similar deduction for similar liabilities. That objective remained in 1984, but a very different course was taken to achieve it. It was here, in the enactment of the section 807(d) rules, that deference to the NAIC emerged in the legislation.

In crafting the 1984 tax law, Congress was aware that state laws and regulations prescribed minimum reserve requirements with respect to life insurance and annuity products. These requirements were largely (though not completely) uniform throughout the nation due to the fact that the NAIC promulgated model laws and regulations relating to valuation of insurers' liabilities. The drafters of section 807(d) appropriated these requirements, more or less, in prescribing the calculation of the so-called federally prescribed reserves (FPR), which serve as one of the limits on the reserve deduction. (The other two limits found in section 807(d)—a minimum deduction based on contracts' net surrender values and a maximum based on the reserve reported in the annual statement—are unique to each insurance company taxpayer.) More specifically, the FPR for a given life insurance or annuity (or today, long-term care insurance) contract is determined using a maximum interest rate generally allowed by state law, a mortality or morbidity table generally required by state law, and a reserve “method” in wide use—all with the intent of providing a deduction based on the minimum amount of reserves generally required by state law. A detailed examination of each of these demonstrates the deference Congress showed to the NAIC's model rules, as well as the degree of that deference.

The interest rate prescribed for the FPR calculation by section 807(d) as originally enacted is the highest rate allowed by a majority of the states in valuing the liability for a contract at the time the contract is issued. This rate, denominated the “prevailing state assumed interest rate” (PSAR) in the tax law, is determined by drawing on formulas contained in uniform state laws that are premised on the NAIC's model valuation law, namely, the Standard Valuation Law. In 1987, Congress added another interest rate to the mix, incorporating into the FPR calculation the *greater* of the PSAR and an “applicable federal interest rate” borrowed from section 846. The latter rate had been developed solely to discount, for tax purposes, the loss reserves principally held by property-casualty insurers. While one may suspect that Congress added that rate to section 807(d) mainly for tax revenue reasons, it retained the PSAR in the calculation, and for a number of years now the PSAR has been the higher rate.

The rule relating to the mortality or morbidity table to be used in the FPR calculation shows even greater deference to the NAIC. The table employed in calculating the FPR for a given contract is generally the “most recent” table prescribed by the NAIC that it is permitted to be used for the type of contract involved by a majority of the states when the contract is issued. Thus, the identification of the table begins with the NAIC’s approval; the statute refers to the “prevailing commissioners’ standard tables,” meaning the state insurance commissioners who make up the NAIC. In the absence of a prevailing table, the Treasury Department may by regulation prescribe the table to be used, and in taking that step the Treasury has typically drawn upon tables approved by the NAIC.⁴

The most striking instance of deference to the NAIC in section 807(d) lies in the rule describing the “tax reserve method.” In this instance, Congress did not provide a direct role for the states, but instead chose to rely exclusively on the NAIC to prescribe the reserve method to be used in the FPR calculation. According to the statute, the CRVM is the commissioners’ reserve valuation method to be used for a contract covered by the CRVM, the CARVM is the commissioners’ annuity reserve valuation method to be used for a contract covered by the CARVM, and in both situations the named method is the one so named and defined by the NAIC that is in effect at the time the contract is issued. Further, for completeness, in the case of a type of contract not listed in it, the statute says to use the NAIC reserve method prescribed for that contract, and if the NAIC has failed to prescribe a method with respect to a contract, the method to be used for the contract must be consistent with one of the methods otherwise listed in the statute. The heavy reliance of the statute on the NAIC’s prescription of the reserve method has broad implications for determining the manner in which section 807(d) will apply to principles based reserves.

It is true that for noncancellable accident and health insurance contracts, section 807(d) does not expressly reference the NAIC, instead specifying the use of a two-year preliminary term method (a one-year preliminary term method is used for qualified long-term care contracts). However, the very definition of a preliminary term method is rooted in NAIC model laws, regulations, and other guidance. On the other hand, in a clear divergence from the NAIC-prescribed reserve method, section 807(d) excludes deficiency reserves from the FPR. Also, to restrict the deduction for reserves so that there is an appropriate matching of income and expense for tax purposes, section 811 denies a deduction for reserves in respect of in-



terest guaranteed beyond year-end at a rate above the section 807(d) interest rate as well as for reserves reflecting deferred and uncollected premiums. In these two situations, the interest earnings and the premiums, respectively, are not included in the insurer’s gross income.

Peter: To summarize what you are saying as to the amount of the deduction for life insurance reserves, in the 1984 Act Congress could be said to have increased deference to the NAIC, except when it imposed specific adjustments, and even for the most important of these adjustments—interest and mortality assumptions—Congress could be said to have indirectly deferred to the NAIC by relying on 26-state rules.

John: That’s right, Peter. Under pre-1984 law, Congress could be said to have deferred to the NAIC indirectly, by accepting as deductible reserves the amounts insurers recorded on their annual statements. But under the 1984 law, Congress explicitly deferred to the NAIC on the reserve method while making use of the NAIC’s rules for the interest and mortality assumptions.

Peter: That’s what Congress did in the 1984 Act for life insurance reserves. What about other types of reserves?

John: As Susan mentioned, section 807(c) places its own limits on the deductible amount of the section 807(c)(3) and (6) reserves. Section 807(c)(3) includes the reserves held for insurance and annuity contracts not involving life, health,

or accident contingencies in the list of deductible items, and section 807(c) requires that the deduction be determined by discounting the annual statement amount for a contract at the greatest of the two rates used for the FPR and the rate assumed by the insurer in determining the guaranteed benefit under the contract. And, in the case of the section 807(c)(6) special contingency reserves for retired lives and premium stabilization,

the deduction is limited to the “reasonable” amount of the reserves.

“There is no second pass through section 807(c)(1) to bifurcate a tax reserve between life and non-life features, nor is there room in the Code to disaggregate the annual statement reserve....”

Peter: So, I guess for these other types of reserves, deference to the NAIC is not as relevant in determining the amount of the deduction. But, let’s go back to the question of the scope of NAIC deference relating to the types of liabilities that we get to deduct on a reserve basis. There is a general rule of statutory construction that terms of art used in the statute that are particular to a specific industry are interpreted consistently with that industry’s understanding of the meaning. This concept has been applied to the insurance provisions of the Internal Revenue Code. It seems to me that in accordance with this rule of statutory construction there should be some deference to the NAIC to the extent current section 807(c) identifies deductible reserves using terms of art. Does it, Tim?

Tim Branch: As the lone actuary on the panel, I’d like to acknowledge that this topic is more in depth than the average valuation actuary normally ventures, and this information and historical perspective may be new to some of our readers. Generally, there is deference to the NAIC and the life insurance industry’s terms of art in categorizing the section 807(c) deductible reserves. However, industry terms of art used by actuaries don’t always line up nicely with the deductible reserve categories outlined in section 807(c). Most actuaries would not have difficulty categorizing life insurance and annuity reserves as section 807(c)(1) “life insurance” reserves (these are typically Exhibit 5 reserves from the NAIC Annual Statement). Section 807(c)(2), concerning “unpaid losses” and “unearned premiums,” gets a little trickier as these terms are not defined in the Code (although they are defined in the regulations).⁶ Generally actuaries look to the statutory defi-

nitions used in the applicable NAIC Statements of Statutory Accounting Principles⁷ for determination of these amounts. But after we get past sections 807(c)(1) and 807(c)(2), and start to look at the terms of art used in the industry compared to the terms used in section 807(c)(3) through (6), things may not always be so clear.

An example of where section 807(c) categories don’t line up nicely with industry terms of art would be certain pension plan contracts. Some pension plan contracts may have permanent annuity purchase rate guarantees, and would be categorized as section 807(c)(1) life insurance reserves, whereas others may be categorized as section 807(c)(3) or (4) reserves if they only have temporary annuity purchase rate guarantees (as Susan mentioned earlier). Under the industry terms or art, both of these contracts would typically be considered “pension plan” contracts by an actuary and not considered separately.

On the other hand, an example of where section 807(c) categories do line up nicely with industry terms of art would be contingent deferred annuities (CDAs), which are a type of longevity insurance where benefits are paid to policyholders if they survive to a specified age and certain designated investments are depleted. The insurance industry and the NAIC both consider this type of product to be an annuity (the NAIC describes progress in “establishing CDAs as a distinct annuity product best sold by life insurance companies”).⁸ In various Private Letter Rulings,⁹ some of which Sheryl may be familiar with, the IRS has deferred to the NAIC and industry’s categorization, and held that these types of contracts are more annuity than financial guarantee. Based on these rulings, it appears that CDAs should be classified as section 807(c)(1) annuity reserves.

As actuaries, we’d like to have a roadmap of how the NAIC reserve categories (e.g., Exhibits 5, 6, 7 and 8 in the NAIC Annual Statement) translate to the corresponding section 807(c)(1) through (6) categories, but unfortunately this is not always possible.

Peter: For me, it is helpful to think of the deductible reserve items listed in section 807(c), not so much classifying them by types of contracts as you might as an actuary, but instead in a time continuum that includes four general categories: pre-effective-date items, such as advance premiums and premium deposits; pre-claim reserve items, such as premium reserves,

active-lives reserves and unearned premiums; claim reserves; and post-claim reserves, such as dividend accumulations and amounts held as interest. Viewed this way, it's easier for me to think about the NAIC deference issue. I ask myself "how does the NAIC annual statement deal with reserve accounting during these various time periods?"

Mark: Whether you try to map the section 807(c) reserve categories to types of contracts or to a time continuum in a single contract's life cycle, I would think you end up with many of the same questions. I do like the "time continuum" you describe, Peter, because it also makes sense of the fact that at some point a claim payable under a particular contract may become a liability of the company and no longer a reserve item at all.

Peter: John mentioned the limitation on the deduction based on statutory reserves. Does deference to the NAIC have any relevance in determining statutory reserves for this purpose?

Mark: It would be hard to say the NAIC is "irrelevant" to any of this, but really the statutory reserve cap defers to what is reported on the annual statement, not what is required by the NAIC. The NAIC is influential in prescribing model laws and regulations, and actuarial guidelines, but here the state insurance regulators are in control. The reason I say this is found in the Code itself: Whereas the computational rules apply the CRVM (or CARVM) "prescribed by the [NAIC]," and the "prevailing" mortality tables and interest rates when the contract is issued, section 807(d)(6) refers simply to "the aggregate amount set forth in the annual statement with regard to items described in section 807(c)." This means that "statutory reserves" means just that, statutory reserves. If a state imposes a different requirement from that set out in NAIC model laws, model regulations, and actuarial guidelines, the state requirements govern.

As a practical matter, the statutory reserve cap prevents a company from deducting more than the amount it has set aside for regulatory purposes, that is, the amount set forth in the annual statement. Other than the Code's instruction to exclude reserves attributable to a deferred and uncollected premium, if such a reserve isn't permitted under the Code's no double-counting rule, it is pretty clear that you pick up what is on the annual statement "with respect to" the reserve items listed in section 807(c). That list is not limited to life insurance reserves.

This is a useful reminder that there are not multiple "bites at the apple" to disqualify life insurance reserves under section 807. Once it is determined that a reserve is a life insurance reserve, section 807(d)(2) prescribes the tax reserve method, and the amount determined under the tax reserve method is bounded by a floor (the contract's net surrender value) and a cap (the annual statement reserve with respect to the contract). There is no second pass through section 807(c)(1) to bifurcate a tax reserve between life and non-life features, nor is there room in the Code to disaggregate the annual statement reserve with respect to a contract between life and non-life features. The Code does not do this; neither does the NAIC nor any state regulator.

Peter: Now that we've spent some time on what Congress did in 1984, I would like to turn to how the IRS has dealt with the issue of NAIC deference in its guidance and in litigation. To stir things up a little, I will make two observations. First, my sense is that the National Office Insurance Branch has been reluctant to fully accept NAIC deference—sometimes even where Congress dictated deference. And, second, on the deference issue, the IRS sometimes has conflated the question of whether the liability is deductible on a reserve basis with the question of how much is deductible. Sheryl, as the last head of the Insurance Branch, you are probably in the best position to comment on the IRS's view on the deference issue.

Sheryl Flum: I want to start by reminding everyone that my comments are my opinions and do not necessarily reflect the views of the IRS or my current employer, KPMG LLP. In order to understand the tension between the IRS and life insurance taxpayers regarding the weight to be given NAIC guidance when interpreting the tax law, we need to recognize that there is an inherent tension between the concerns of the NAIC and the concerns of the IRS. The reserve rules put forth by the NAIC are intended to ensure that insurance companies remain financially stable and have sufficient funds available to pay policyholder claims. In other words, the NAIC's primary concern is consumer protection. The Internal Revenue Code should be interpreted so that all taxpayers' taxable incomes are determined fairly and uniformly, and the IRS's interpretations tend to focus on not providing unfair advantages or windfalls to any one group of taxpayers. Given this difference in starting points, it is no surprise that statutory reserving principles have historically tended to be more conservative, i.e., often yielding higher reserves, than the income tax rules for computing reserves.

CONTINUED ON PAGE 28

The legislative history from 1984 indicates that Congress intended that the federally prescribed reserves (FPR) be computed differently than the statutory reserve used for NAIC purposes. The IRS has taken the position that Congress intended that any interpretation of CRVM or CARVM for purposes of the FPR look to tax principles, and not to consumer protection principles. But the plain language of section 807 provides that CRVM and CARVM are prescribed by the NAIC. So to comply with the statute, the government views the FPR's starting point as the CRVM and CARVM as prescribed by the NAIC and then adjusted, as appropriate, to comply with tax principles.

To complicate matters, it seems that Congress's understanding in 1984 of how reserve methods were determined by state regulators was not completely accurate. Congress appears to have assumed that there would always be a prevailing reserve method for any life insurance product even if the NAIC had not issued an Actuarial Guideline or other requirement standardizing the operation of the reserve method. In reality, though, such standardization either does not exist or is not sufficiently documented by state insurance regulators for taxpayers (or the IRS) to rely upon. Nonetheless, the IRS interpreted section 807(d)(3) to mean that there was always an identifiable prevailing reserve method that would be applicable to any life or annuity contract as of the date the contract was executed.

The government has taken the position that CRVM and CARVM must be static over the life of the contract. Even though the IRS recognized in Rev. Rul. 94-74¹⁰ that a company could choose to switch reserve assumptions within a method between two acceptable approaches (i.e., continuous v. curtate functions), it also took the position that once a life insurance company adopts a reserve method that is accepted by its regulator, that method must be the company's reserve method and the company cannot change to a different acceptable method. This disconnected position has led to litigation¹¹

In *American Financial*,¹² the taxpayer used a reserve method accepted by its regulator in computing statutory reserves for variable annuity contracts at the time those contracts were issued. It used that same reserve method to determine its FPR. Several years later, the NAIC issued AG 33 and the taxpayer changed its reserve method for both FPR and statutory purposes to that prescribed by AG 33. The IRS disallowed the reserve adjustment, asserting that the method employed prior to AG 33's adoption was a prevailing method and the

taxpayer must continue to use for FPR purposes the reserve method prescribed as of the date the contracts were issued. The taxpayer argued that section 807(d) requires that the FPR be determined using the reserve method prescribed by the NAIC, and the NAIC required that AG 33 be applied for all contracts written after 1981. It further argued that the method prescribed by AG 33 was an acceptable reserve method that it could have chosen to use even before AG 33 was issued. The Sixth Circuit's opinion affirming the District Court's holding in favor of the taxpayer is quite instructive. The court clearly explains that the Internal Revenue Code defers to the NAIC to determine the method to apply for computing the FPR. The opinion interprets section 807(d)(3)(B)(ii) to mean that if the NAIC replaces the Standard Valuation Law or materially amends it, or issues new interpretive regulations, or issues an actuarial guideline that materially changes the commissioners' method, the taxpayer would be able to use that new reserve method prospectively only, but that AG 33 did not materially change the CARVM. Since the IRS has not issued an Action on Decision on *American Financial*, we do not know whether the government will continue to assert that CARVM and CRVM must be static.

Tim: It's also noteworthy that in the introduction to "Appendix C Actuarial Guidelines" of the NAIC's "Accounting Practices and Procedures Manual," the NAIC states that the guidelines are "merely a guide to be used in applying a statute to a specific circumstance," and not intended to be viewed as "statutory revisions." Based on the *American Financial* decision, it appears that the court deferred to the NAIC's own assessment of the role of its guidelines.

Peter: You have put your finger on the dispute in this area. Taxpayers, like *American Financial*, say that, with respect to the method for computing the FPR, the Code defers to the NAIC and the IRS has said "not always." In general, the IRS has agreed that deference is required to the method as defined by the NAIC at the time the contract is issued—but not if the NAIC later changes its mind and not if the NAIC's method includes a type of reserving method the IRS does not like (for example, stochastic reserves).

Tim: There has also been another recent case, *Acuity v. Commissioner*, involving property and casualty tax reserves that ended favorably for the taxpayer based on deference to the NAIC reserves. At issue were the insurance company's reserves used to determine underwriting income under section 832(b)(1)(A), which defers to reserves "computed on

the basis ... of the annual statement approved by the National Association of Insurance Commissioners.” The IRS claimed that the company’s reserves were excessive, however, the court’s opinion held that Acuity’s reserves were “computed in accordance with the rules of the [NAIC] and the Actuarial Standards of Practice (ASOPs) and ... fell within a range of reasonable reserve estimates,”¹³ and the deduction was allowed.

Peter: There’s another property/casualty case, *State Farm*,¹⁴ that bears directly on the deference issue—specifically the important difference between deference to the NAIC and deference to a single state regulator.

Sheryl: The relevant part of the *State Farm* case involved the company’s treatment of \$202 million liability for compensatory and punitive damages due to a finding of bad faith in State Farm’s handling of an accident claim. State Farm included the liability as a discounted unpaid loss under section 832(b)(5). The IRS challenged by asserting that losses incurred must be “on the insurance contract” and that awards for bad faith were outside the scope of the contract. The Tax Court ruled in favor of the IRS, and State Farm appealed.

The Seventh Circuit reversed the Tax Court’s holding with regard to the compensatory damage awarded for bad faith because Congress intended that unpaid losses be determined by reference to the amount reported on the Annual Statement. The Annual Statement, of course, uses NAIC rules and regulations. The court actually held that deference to the NAIC’s determination of unpaid losses is built into the Code. Since the NAIC requires non-life insurance companies to include extra-contractual compensatory liabilities as unpaid losses for statutory purposes on the Annual Statement, the court held that the compensatory liability at issue must be deductible.

Peter: I think *State Farm* is important because the deference to the NAIC was on the question of whether a particular type of liability can be considered part of deductible reserves, not strictly on the computational issue. Also, it’s important what the court said about single state reserve requirements.

Mark: Well, that’s where it gets interesting. In its analysis of the punitive damages issue, the Seventh Circuit had to address head-on the company’s argument that various auditors and state regulators had approved the company’s annual statements for the years at issue and had not taken exception to the inclusion of punitive damages in unpaid losses. The Seventh

Circuit gave this argument no weight, and went so far as to say “[w]e are not bound by the section 832 statutory language to consider the views of any auditor or regulator other than the NAIC as a whole.”¹⁵ I find that remarkable, especially since the statutory reserve cap in section 846(a)(3) for non-life reserves makes specific reference to “the annual statement filed by the taxpayer.” The rule seems to be that for nonlife reserves, NAIC methods control over single state requirements in computing the tax reserve, but not for purposes of applying the statutory cap on tax-deductible reserves. The analogies to section 807 here are striking.

Tim: That’s right. Care must be taken when certain state insurance departments allow permitted reserving practices which may be different from the method prescribed by the NAIC. It’s important to remember that in these situations where deviations from the NAIC method are allowed for statutory purposes, the method prescribed by the NAIC (in effect at the issuance of a contract) must still be used to determine the appropriate FPR for tax purposes. However, the statutory cap would still be based on the “amount set forth in the annual statement” (i.e., the amount computed under the permitted practice).

Mark: If there were ever any doubt about the IRS’s thoughts on a single state’s requirements versus NAIC-prescribed methods, one really ought to re-read the Technical Advice Memorandum on the Connecticut Method of reserving for Guaranteed Minimum Death Benefits.¹⁶ There, the IRS rejected a company’s argument that it should be allowed to use an approach based on an assumed one-third drop in asset values, on the theory that the method was more conservative than that required by the other 49 states. Rightly or wrongly, this is an area where the IRS has taken a very literal approach to the single state issue.

John: Sheryl makes a good point about the difficulty of determining the details of the prevailing reserve method in some instances. Congress deferred to the NAIC on the method because it had no method of its own to suggest, apart from desiring that a preliminary term method be used for life insurance and noncancellable A&H. When section 807(d) was enacted, the use of actuarial guidelines was in its infancy, and they were not even mentioned in the statute’s legislative history. While Congress presumed the existence of an NAIC-prescribed method, at least in the case of life insurance and annuity contracts, it sensed (or was told) that the details would

CONTINUED ON PAGE 30

not always be spelled out by the NAIC, and so it instructed in the legislative history that if specific factors in the reserve method are not prescribed by the NAIC, the prevailing state interpretation of those factors should be considered.¹⁷ Unfortunately, we are not told how to determine the prevailing state interpretation, and there is no single source of guidance on what that interpretation is.¹⁸

Peter: I have always interpreted this legislative history to mean that if the NAIC has not specifically prescribed a reserve factor, then we can look to the 26-state interpretation because, after all, 26 states represent a majority of the NAIC. So, to me, this legislative history is still just part of the 1984 Act's deference to the NAIC with respect to the tax reserve method. But, this 26-state rule in the legislative history should only apply if there is a clear majority state view as to a required factor (because otherwise there is no quasi-NAIC action). This situation has not come into play often.

Mark, Sheryl has discussed how the NAIC-deference issue has led to conflicts in implementing new NAIC actuarial guidelines. Let's go back to your earlier comments. What about the related deference issue as to whether the full NAIC-prescribed reserve is deductible as part of the FPR—for example the Conditional Tail Expectation (CTE) Amount under AG 43 for variable annuities? Do we defer to the NAIC if it defines CRVM or CARVM to include a stochastic reserve or does the IRS have the authority to say a portion of the reserve is non-deductible?

Mark: I personally believe there are compelling arguments for including the CTE Amount in the FPR, simply under the plain language of the Code. The FPR is determined using "the tax reserve method," which in turn means either the CARVM or CRVM that applies to the contract as prescribed by the NAIC. I don't see the Code as giving discretion to IRS to disaggregate, or bifurcate, a reserve that is a CARVM reserve under NAIC guidance. For a variable annuity that is governed by AG 43, a reserve that excludes a positive CTE Amount does not satisfy CARVM, period. What would be left of a reserve if IRS had discretion to remove some features that CARVM itself requires? Would the remaining reserve still be a CARVM reserve? Would something be added in substitution of the features excluded? What in the world would that be?

Notice 2010-29¹⁹ was a useful first step in this area, providing interim guidance to companies that the IRS would honor as it

continued to study the operation of AG 43 and the emergence of Life PBR. Notice 2010-29 was never intended to be the last word in this area, and at some point will become problematic if it functions as permanent, substantive guidance. The Notice's silence about the statutory reserve cap should not be read to create a negative inference about the inclusion of the CTE Amount in the cap. That issue was under consideration in 2010 and has been on the Priority Guidance Plan ever since. Likewise, the Notice's instruction not to include the CTE Amount in the FPR was included, in part, because the IRS was still considering the reasonableness of the allocation methodology that AG 43 itself uses to allocate the CTE Amount to individual contracts. The operation of that methodology in practice is now better understood, and a fresh look is warranted.

The same issue will present itself with the adoption of Life PBR: What is the status of the Stochastic Reserve and is it included in the FPR for tax purposes? At least to me, it is hard to imagine the IRS resolving that issue in a way that is inconsistent with its treatment of the CTE Amount under AG 43.

Sheryl: I agree with Mark that the CTE Amount is part of CARVM and should be accounted for in the FPR. However, the reserve method is only one part of the FPR. The FPR also requires use of a mortality or morbidity table required by state law and a maximum interest rate prescribed by either state or federal law. The CTE Amount is not computed using either a standard table or the maximum interest rate. So in order to include the CTE Amount in the FPR, the CTE Amount would need to be recalculated. The administrative complexity of such a recomputation would likely make it uneconomic to actually include the CTE Amount in the FPR even if it is part of CARVM.

Mark: Notice 2008-18 suggested a handful of alternative approaches to address what interest rate and mortality tables should apply to compute an FPR that includes a stochastic component such as the CTE Amount. In practice, some of those approaches might be dismissed as uneconomic and some might not. It depends on what approaches are taken. I think at least some of those approaches were administrable.

Peter: I don't think the problem is the cost; it is more the problem of trying to fit a square peg into a round hole. A good argument can be made that the CTE Amount must be included in the FPR because it is needed to comply with the NAIC's prescribed CARVM, but that no adjustment is required for

the interest rate because making such an adjustment would do violence to CARVM, likely not reduce tax reserves and make no sense. In other words, the requirement to use the AFIR in section 807(d) should only apply when the use of a single discount rate is compatible with the NAIC-prescribed method. I also think that the IRS's notices present two additional problems with respect to stochastic reserves that the NAIC has required to be part of CRVM or CARVM. The first problem is that the IRS has not caught up with the way courts now look at statutory construction—and the requirement to apply the plain language of the statute. The second problem is an apparent assumption on the part of the IRS that stochastically computed reserves are surplus reserves held for asset inadequacy, rather than deductible insurance reserves.

John: Peter, I agree that it is difficult to reconcile the plain language of section 807(d) with Notice 2010-29's hesitation to include the CTE Amount in either the FPR or the statutory cap. As Mark pointed out, section 807(d) looks to the NAIC to prescribe the tax reserve method, and in AG 43, the NAIC prescribed a method that included the CTE Amount in the reserve. Without the CTE Amount when it exceeds the Standard Scenario Amount (SSA), the reserve established is not a reserve according to the CARVM. The same will be true of the Stochastic and Deterministic Reserves under Life PBR when SVL II and VM-20 come on line. A Life PBR reserve that omits those elements when they exceed the net premium floor will not be a reserve according to the CRVM. The IRS may be concerned about where this brave new world will lead, but the statute says what the statute says: Congress in 1984 relied on the NAIC to define what is the reserve method. The courts will enforce the statute and will observe that if there is a problem with the statute, the resort is to Congress, and only to Congress.

Peter: With four years of AG 43 under our belt, it has become clear that the SSA of AG 43 standing alone is not a sufficient CARVM reserve, particularly in light of the reduction of the SSA for approved hedges. This calls into question whether the interim guidance in Notice 2010-29 should be reconsidered. If it isn't, the Notice's validity is likely to be challenged.

Tim, what about my second point – from an actuarial perspective is the Notice's implication correct that all stochastic reserves should be treated as non-deductible reserves for asset inadequacies?



Tim: It's not explicit in the Notice that *all* stochastic reserves should be treated as non-deductible reserves; the interim guidance simply says that the CTE Amount is not taken into account for purposes of determining the federally prescribed reserve under section 807(d)(2). It does not go on to say why the CTE Amount is not taken into account, which leaves us to speculate that the IRS may consider it to be similar in nature to a deficiency or asset adequacy reserve (neither of which are deductible under section 807). The Notice goes on to say that no inference can be drawn for purposes of Life PBR or other tax issues, so it's not a certainty that other stochastic reserves will be treated as non-deductible (although it appears the IRS may be headed in that direction). Part of the IRS's reluctance to include stochastic reserves as life insurance reserves may come from the degree of actuarial judgment involved in setting these reserves. Instead of a constant, deterministic projection and discount rates, the CTE Amount is calculated using 1,000 (or more) stochastically generated economic paths. Instead of prescribed assumptions, prudent estimate assumptions are determined by the actuary based on relevance, availability and credibility. The concepts of actuaries choosing reserve assumptions, and multiple economic scenarios, deviates from the "prescribed" and "prevailing" language in the Code (although one can make the argument that these prudent estimates are "prescribed" by the AG). The lack of historical reserve trends of stochastic reserves may also be troubling

CONTINUED ON PAGE 32

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

Timothy Branch FSA, MAAA, is a manager at Ernst & Young LLP and may be reached at [tim.branch@ey.com](mailto:branch@ey.com).

Sheryl Flum is a managing director in the Financial Institutions and Products group of KPMG LLP's Washington National Tax practice. She can be reached at sflum@kpmg.com.

Susan Hotine is a partner with the Washington, D.C. law firm Scribner, Hall & Thompson, LLP and may be reached at shotine@scribnerhall.com.

Mark S. Smith is a managing director in PwC's Washington National Tax Services and may be reached at mark.s.smith@us.pwc.com.

to the IRS; the industry is still adjusting to the less predictable nature of the CTE Amount for statutory purposes, and there may be a concern in the IRS about the predictability of taxable income produced by these types of reserves. Again, the Notice is meant to provide interim guidance, so the IRS may be taking a “wait and see” approach with respect to stochastic reserves.

Peter: Your comment highlights one of the primary reasons we are having this dialogue. It may be true that the IRS has all these concerns about stochastic reserves, but I question whether the IRS has the authority to say that they are not part of the deductible FPR if the NAIC has prescribed them as an essential component of CRVM or CARVM reserves. I also think there is a distinction to be drawn between a stochastic reserve that is designed to arrive at a minimum reserve to be held for the specific class of contract benefits and an asset adequacy reserve that is computed after the minimum reserve has been established and determined of the basis of the company's total assets and liabilities. Both types of reserves may be based on cash flows from multiple scenarios using actuarial judgment, but their purpose and character are materially different.

Mark: I think you've hit the nail on the head. Life insurance reserves represent the value of a company's obligations to its policyholders. When those reserves are computed by reference to asset values or models of asset values, some may mistakenly assume that the reserves are established to protect the company as owner of those assets. This is a dangerous and sometimes incorrect leap, because sometimes the risk that asset values will change represents a risk that more will be owed to the policyholder. The only way to make sense of this is to stay focused on the purpose of the computation: is it a measurement of the minimum reserve to be held to satisfy or liquidate obligations to policyholders, or is it instead determined after such a minimum reserve is computed, based on the assets and liabilities of the company? The trend to using stochastic reserves for statutory purposes obviously makes the issue important for tax as well. This is a current challenge for a system that both disallows deductions for asset adequacy reserves and defers to statutory accounting as defined by the NAIC.

Peter: Now that we've identified some of the issues of NAIC deference under prior law and current law, let's look to a future. Susan, how did former Ways & Means Committee Chairman Camp deal with the deference issue?

Susan: Under the Camp Discussion Draft, the current-law prescribed discount rate for life insurance reserves would be replaced 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. The effect of the provision on computing reserves for contracts issued before the (2015) effective date would be taken into account ratably over the succeeding eight tax years (there would be no “fresh start”). For the tax reserve computation, the Camp Discussion Draft retains the use of the NAIC recommended reserve method for tax reserves (and so the deference to the NAIC in that area). However, by setting a new federally prescribed assumed interest rate and eliminating the use of the prevailing state assumed interest rate entirely from the tax reserve computation, Camp's Draft moves away from any NAIC deference with respect to permitted assumed interest rates.

Peter: That's what the Camp Draft would do. From your experience in helping draft the 1984 Act, and from lessons learned under the 1984 Act, what do you think Congress should do in comprehensive tax reform on the deference issue for tax reserves?

Susan: The problem for a comprehensive tax reform that covers life insurance companies is pretty much the same as it was for the Congress in 1984. Life insurance companies issue contracts that have potential liabilities far into the future; even though premiums may be paid currently, and invested to earn current investment income, the companies' use of the premiums and investment income is limited and restricted by state insurance regulators through minimum reserve requirements. Because of those regulatory restrictions, the companies do not have free use of all their assets as might be the case for non-insurance companies. The tax code has generally recognized the uniqueness of an insurance company's regulatory restrictions for maintaining required reserves by allowing a reserve deduction. By adopting certain prescribed rules for computing tax reserves, Congress regularized the amount of the deduction among similarly situated companies, which the Camp Discussion Draft would continue and which I think would be important under any comprehensive tax reform proposal. At the same time, by incorporating a clear deference to the NAIC, current law contains an implicit acknowledgment that an insurance reserve computation is not your typical “present value” tax computation. As with other industries, the life insurance industry's products are ever evolving,

incorporating new benefits and factors to consider. The NAIC reserving recommendations are designed to address these evolving benefits and other factors, to properly measure a life insurance company's future liabilities. I think it would be important for any comprehensive tax reform proposal to continue a deference to NAIC reserving recommendations so that the Code maintains flexibility for the computation of tax reserves to address evolving industry products in the future.

John: Agreed. Given the complexity of insurance products today, the statutory reserving rules necessarily must be complex, and if Congress desires to impose tax on the income of companies, there seems little choice but to follow the NAIC's rules as to the reserve method. To do otherwise risks imposing tax without regard to income.

Peter: I'd like to thank the panel for this lively discussion on tax reserves. I look forward to our continuing discussion of the deference issue as it relates to product tax issues. Until then◀

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of their current or former employers.

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at pwinslow@scribnerhall.com.

END NOTES

- ¹ S. Prt. 98-169, Vol I, at 527, n.7 (1984).
- ² Joint Comm. Tax'n, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) 598 (1984).
- ³ *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148, 151 (1977).
- ⁴ See Treas. Reg. § 1.807-1.
- ⁵ *Mutual Benefit Life Ins. Co. v. Commissioner*, 488 F.2d 1101 (3d. Cir. 1973); *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Ct. Cl. 1967).
- ⁶ Treas. Reg. § 1.801-3.
- ⁷ "SSAP 53 Property Casualty Contracts – Premiums," "SSAP 54 Individual and Group Accident and Health Contracts."
- ⁸ http://www.naic.org/cipr_topics/topic_contingent_deferred_annuities.htm.
- ⁹ See PLR 201117013; PLR 201117012; PLR 201105005; PLR 201105004; PLR 201001016; PLR 200949036; PLR 200949007.
- ¹⁰ 1994-2 C.B. 157.
- ¹¹ See *American Financial Group v. United States*, 726 F. Supp. 2d 802 (S.D. Ohio), *aff'd*, 678 F.3d 422 (6th Cir. 2012); *Cigna Corp. v. Commissioner*, T.C. Memo. 2012-266.
- ¹² T.C. Memo. 2013-209.
- ¹³ *Id.*
- ¹⁴ *State Farm Mutual Automobile Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012).
- ¹⁵ 698 F.3d at 366.
- ¹⁶ Technical Advice Memorandum 200448046.
- ¹⁷ See Joint Comm. Tax'n, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) 601 (1984).
- ¹⁸ For a discussion of this subject, see Edward Robbins and Richard Bush, *Tax Basis Assets and Liabilities of U.S. Life Insurers* pp.106–107 (ACTEX Publications 2014).
- ¹⁹ 2010-15 I.R.B. 547.



REPORTING THE COSTS AND BENEFITS OF THE 3Rs

By Maureen Nelson, Matthew Haaf and Megan Lansden

Congress enacted the Affordable Care Act¹ (ACA) with the simultaneous goals of decreasing the number of individuals without health insurance coverage, increasing the quality of health insurance coverage, and reducing the costs of coverage for individuals and the government. As part of the effort to achieve these goals, beginning in 2014 the ACA requires that each issuer that offers a qualified health plan (QHP) on the marketplace “Exchange,”² individual health insurance coverage sold outside of the Exchange, or small group market coverage must provide insurance that meets certain minimum standards of coverage without adjusting rates for pre-existing conditions or the gender of the insured.

In order to encourage issuers to offer health insurance coverage on the Exchange and on the individual and small group markets, while ameliorating the potential impact on any particular health insurance issuer of providing coverage without pricing for pre-existing conditions or the gender of the insured, the ACA includes three risk-sharing programs. These programs, which began in 2014, are the Transitional Reinsurance program,³ the Risk Corridor program⁴ and the Risk Adjustment program⁵ (collectively referred to as the “3Rs”). The Risk Adjustment program operates to spread the risks of adverse selection among the health insurance issuers operating within a particular state, and the Transitional Reinsurance and Risk Corridor programs operate to improve risk on a national level. The Transitional Reinsurance and Risk Corridor programs are temporary programs effective for 2014-16; the Risk Adjustment program is permanent.

The financial and tax reporting of each health insurance issuer is affected by the implementation of these risk-sharing programs because each health insurance issuer is required to pay for the programs’ costs, and some issuers are or will be eligible for benefits under them. To fund the costs of the 3Rs, assessments are levied on health insurance issuers (and, in the case of the Transitional Reinsurance program, on sponsors of self-insured group health plans).⁶ These assessments in turn pay for distributions to eligible health insurance issuers, program administrative expenses and contributions to the U.S. Treasury.

For statutory reporting, guidance as to the characterization and recognition of the assessments and potential distributions under the different programs is found in National Association of Insurance Commissioners (NAIC) Statement of Statutory Accounting Principles (SSAP) No. 107, *Accounting for the Risk-Sharing Provisions of the Affordable Care Act*. To date, the Internal Revenue Service (IRS) has provided limited published guidance on the tax implications of these risk-sharing programs.⁷

TRANSITIONAL REINSURANCE PROGRAM

The Transitional Reinsurance program is intended to provide temporary relief to health insurance issuers from some of the claim costs incurred for coverage provided to individuals with significant health care needs (“high-risk individuals”) under certain non-grandfathered health insurance products.⁸ It operates by creating one or more “applicable reinsurance entities” that will collect amounts assessed on issuers of individual and group health plans and on sponsors of self-insured group health plans⁹ (collectively, “covered entities”) and will make program distributions.¹⁰ The Transitional Reinsurance program is designed to fund a reinsurance pool,¹¹ pay the administrative expenses of the applicable reinsurance entities¹² and make a contribution to the U.S. Treasury.¹³ Under the Transitional Reinsurance program, a health insurance issuer is only eligible for distributions from an applicable reinsurance entity for costs associated with its issuance of individual insured health products that are subject to the 2014 ACA market reforms. For costs associated with other insured health products, including coverage sold under individual grandfathered plans, group health plans and self-insured health products, program distributions are not available.

Each covered entity is required to submit a report to HHS that provides its annual enrollment count by November 15 of the coverage (i.e., benefit) year. The amounts assessed are based on the number of individuals insured by the covered entity, whether pursuant to an individual plan, a group plan or a self-insured plan. For the 2014 coverage year, the reinsurance assessment was \$5.25 per enrollee per month or \$63 for the entire coverage year; at least \$52.50 per enrollee must have been

paid no later than Jan. 15, 2015, and the remaining \$10.50 per enrollee must be paid no later than November 15, 2015.¹⁴ HHS will tell each covered entity how much of its total assessment HHS is allocating to the U.S. Treasury contribution from the program.

The applicable reinsurance entities will make reinsurance program distributions to reimburse issuers of eligible individual insured health products for a portion (coinsurance rate) of the total cost of benefits provided for a coverage year that is in excess of a specified minimum total cost (attachment point) up to a maximum total benefit cost (cap). For the 2014 coverage year, the coinsurance rate is 80 percent, the attachment point is \$45,000 and the cap is \$250,000.¹⁵ An eligible covered entity may submit claims for reimbursement to the applicable reinsurance entity through April 30 of the year following the benefit year. HHS will distribute reinsurance program funds among issuers nationally based on submitted claims. Issuers will be notified of pending reinsurance distributions by June 30 of the year following the benefit year.

Statutory Accounting Treatment

For coverage provided to enrollees in an individual non-grandfathered plan that is eligible for reinsurance program distributions, SSAP No. 107 requires reinsurance program assessments to be divided into two parts. One part funds the reinsurance pool and pays the administrative expenses of the applicable reinsurance entity operating the reinsurance pool, and the other part funds the amount payable to the U.S. Treasury. The portion of the reinsurance program assessment that funds the reinsurance pool and pays its administrative expenses is accounted for as ceded reinsurance premium in accordance with SSAP No. 61R, *Life, Deposit-Type and Accident and Health Reinsurance*, and recorded as a reduction to premium income for the coverage period. Similarly, amounts received by a covered entity for reinsurance program distributions are reported as ceded claim benefit recoveries with distributions receivable from the reinsurance program reported in the same manner as traditional reinsurance recoveries, as described in SSAP No. 61R. The portion of the reinsurance program assessment that funds the amount payable to the U.S. Treasury is to be accounted for as an expense for “taxes, licenses and fees” that must be recorded when the liability for this payment attaches and the amount can be reasonably estimated (i.e., when the coverage is issued), consistent with SSAP No. 35R, *Guaranty Fund and Other Assessments*.



For coverage provided to enrollees in all other plans that are not eligible for reinsurance program distributions, SSAP No. 107 requires reinsurance program assessments (including both the portion going to the applicable reinsurance entity and the portion going to the U.S. Treasury) to be treated as assessments payable by the reporting entity and charged to “taxes, licenses and fees” when the coverage is issued, consistent with SSAP No. 35R. Reinsurance program assessments made on behalf of a self-insured plan administered by the reporting entity are passed through to the self-insured plan and are not reported as revenues or expenses by the reporting entity, consistent with SSAP No. 47, *Uninsured Plans*.

Federal Income Tax Treatment

We anticipate that many issuers will reflect the payments and recoveries accounted for as adjustments to premiums in taxable income in the year they are recorded on the Annual Statement for statutory reporting.¹⁶ One potential question is whether the portion of the assessments treated as “taxes, licenses and fees” for statutory accounting purposes is deductible as an expense incurred within the meaning of IRC §832(b)(6) in the year it must be recorded as an expense for statutory accounting purposes or when “economic performance” under IRC §461(h) has occurred and therefore the “all events” test has been satisfied. If a health insurance issuer is required to satisfy the economic performance test before it may deduct the portion of the reinsurance program assessment reported on its Annual Statement under the category of “taxes, licenses and fees,” then the next question is whether this liability is the type of liability for which the recurring item exception is permitted.

CONTINUED ON PAGE 36

If economic performance is required, the liability to pay the assessments imposed under the Transitional Reinsurance program would be a “payment liability” under Treas. Reg. §1.461-4(g). One type of payment liability eligible for the recurring item exception is described under Treas. Reg. §1.461-4(g)(6), which is captioned “Taxes” but which addresses both taxes and “licensing fees.” Treas. Reg. §1.461-4(g)(6)(ii) describes licensing fees as follows: “If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.” Under the ACA, all covered entities issuing insurance in the individual and small group markets must pay the transitional reinsurance assessment (or face significant penalties) and it must be paid to a governmental authority (either to the U.S. Treasury or to the applicable reinsurance entity operated by either HHS or a state). This argues for concluding that these amounts qualify as licensing fees and would be eligible for the recurring item exception for a health insurance issuer that has elected the recurring item exception for this type of tax item, which would enable an electing health insurance issuer to deduct this expense in the year the liability is incurred.

RISK CORRIDOR PROGRAM

The Risk Corridor program applies to QHPs offered on the Exchange and to policies or plans substantially similar to QHPs offered on the individual and small group markets outside of the Exchanges.¹⁷ The program provides limitations on health insurance issuers’ losses and gains for QHPs by creating a mechanism for risk sharing for allowable costs between the federal government and the QHP issuers, thus providing QHPs additional protection against initial pricing risk. For each QHP sold by a health insurance issuer, the health insurance issuer must calculate its “allowable costs”¹⁸ (i.e., medical claim payments plus quality improvement costs) and compare those to a “target amount”¹⁹ (i.e., premiums collected reduced by “allowable administrative costs”).²⁰ The allowable costs for a QHP are then compared to the target amount and if the QHP has exceeded the target amount by 103 percent or more, the issuer of the QHP is entitled to a distribution from HHS under the Risk Corridor program.²¹ If the allowable costs for a QHP are less than 97 percent of the target amount, the issuer is required to remit an assessment to HHS under the Risk Corridor program.²² Issuers are required to report their target amounts and allowable costs for each QHP to HHS by July 31 of the year following the benefit year. After receiving this information, and after the adjustments

related to the Transitional Reinsurance and Risk Adjustment programs have been determined, HHS will calculate the risk corridor assessments and distributions and issue invoices to QHP issuers for assessments due.

Arguably, the ACA as enacted could have required HHS to make total risk corridor distributions to QHP issuers for a coverage year in excess of the total risk corridor assessments collected from QHP issuers for that coverage year, although HHS expected assessments collected to be sufficient to cover distributions under the program. The so-called “CRomnibus” legislation,²³ passed by Congress just before the end of 2014, includes a provision requiring HHS to limit total risk corridor distributions to eligible health insurance issuers to total risk corridor assessments received by HHS.

In guidance issued as a “Q&A,” HHS advised that if assessments collected for 2014 were insufficient to cover distributions, distributions would be reduced on a pro rata basis and assessments collected for 2015 would first be used to pay, in a proportional manner, the remaining amounts owed to QHP issuers for 2014. The same procedures will be used for making risk corridor distributions for 2015. In the Q&A, HHS indicated that if it appears that assessments for all three years under the existing rules will be insufficient to make all risk corridor distributions owed to QHP issuers, it would provide additional guidance for calculating risk corridor assessments owed by QHP issuers for 2016.

Statutory Accounting Treatment

Under SSAP No. 107, assessments and distributions under the Risk Corridor program are treated like premium adjustments for retrospectively rated contracts under SSAP No. 66, Retrospectively Rated Contracts. As such, they increase or decrease premium revenue over the contractual period of coverage based on experience to date and are recognized to the extent that such increases or decreases are reasonably estimable. Receivables under the Risk Corridor program are considered receivables from a federal government program. Accordingly, amounts outstanding over 90 days will not cause the receivable to be treated as a nonadmitted asset based solely on aging. SSAP No. 107 requires, however, that an issuer evaluate the collectability of any risk corridor receivable and charge any uncollectible amounts to income in the period it is determined that such amounts will not be collected, in accordance with SSAP No. 5R, Liabilities, Contingencies and Impairments of Assets.

Federal Income Tax Treatment

We anticipate that many issuers will reflect the assessments and distributions accounted for as adjustments to premiums in taxable income in the year they are recorded on the Annual Statement for statutory reporting. This suggests that an issuer unable to estimate its distribution for the 2014 benefit year and waiting until the earlier of notice or receipt of a distribution to record it on its Annual Statement may wait until the earlier of notice or receipt of a distribution to include it in taxable income.

RISK ADJUSTMENT PROGRAM

As explained in SSAP No. 107, the purpose of the Risk Adjustment program is “to transfer funds from lower risk plans to higher risk plans within similar plans in the same state in order to adjust premiums for adverse selection among carriers caused by membership shifts due to guarantee issue and community rating mandates.” The accounting elements of the Risk Adjustment program, which must be considered separately, include the user fee and the risk adjustment assessment or distribution.

The user fee supports the administration of the Risk Adjustment program and is imposed on all issuers of health plans (except certain exempt and grandfathered plans) in the individual and small group markets within a particular state, whether sold on or outside of the Exchange (each, a “reporting entity”). It is paid to the administrator of the program (in most instances, HHS), is charged monthly on the basis of premiums written and is collected in July following the close of the benefit year when risk adjustment assessments are collected.²⁴

The risk adjustment assessment is imposed on a reporting entity if the actuarial risk score of the enrollees in the reporting entity’s health plans for the coverage year is determined to be less than the average risk score of other reporting entities within that market and state after certain adjustments are taken into account. The actuarial risk score of a reporting entity is determined by the program administrator under a complex methodology set forth in HHS regulations that takes into account various factors affecting a reporting entity’s costs of providing its promised coverage for the year, including each insured’s demographics and diagnoses. Risk adjustment assessments are made by June 30 of the year following the benefit year and must be paid within 30 days of notification of the assessment (i.e., by July 30).

A reporting entity will be eligible for a risk adjustment distribution if its actuarial risk score for the coverage year is determined to be greater than the average risk score of other reporting entities within that market and state. Because the source of funds for risk adjustment distributions is risk adjustment assessments, distributions will be made only after assessments are paid in July.

Statutory Accounting Treatment

SSAP No. 107 requires that risk adjustment assessments and distributions be treated as adjustments (decreases or increases) to premium revenue. A reporting entity will record such adjustments in the period in which the changes in risk scores of its enrollees result in reasonably estimable decreases or increases. An adjustment that is estimated for the portion of the policy period that has expired is reported as an immediate adjustment to premium revenue. The user fee is recorded as an expense for “taxes, licenses and fees” when the premium subject to the user fee is written, consistent with SSAP No. 35R.

Federal Income Tax Treatment

Similar to the transitional reinsurance assessments and distributions, we expect that many issuers will reflect the assessments and distributions accounted for as adjustments to premiums in taxable income in the year they are recorded on the Annual Statement for statutory reporting. An issuer should consider whether the user fee treated as “taxes, licenses and fees” for statutory accounting purposes may be deducted as an expense incurred under IRC §832(b)(6) in the year it must be recorded as an expense for statutory accounting purposes or may only be deducted when the “economic performance” test under IRC §461(h) is satisfied. If economic performance is required, the issuer should also consider whether the “recurring item exception” under IRC §461(h)(3) is available.

Health insurance issuers’ facts and circumstances differ based on product line, use of estimates, Annual Statement presentation, previous accounting methods, etc. Accordingly, tax professionals will need to work closely with financial accounting professionals to determine the appropriate tax treatment of the required assessments and potential receivables under the 3Rs when determining proper tax reporting for 2014. ◀

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

CONTINUED ON PAGE 38

Maureen Nelson is an executive director in the Business Tax Advisory practice with Ernst & Young LLP and may be reached at maureen.nelson@ey.com.

Matthew Haaf is a partner in the Business Tax Advisory practice with Ernst & Young LLP and may be reached at matthew.haaf@ey.com.

Megan Lansden is a senior manager in the Global Compliance and Reporting practice with Ernst & Young LLP and may be reached at megan.lansden@ey.com.

END NOTES

- ¹ The Affordable Care Act refers to the Patient Protection and Affordable Care Act (enacted March 23, 2010, Pub. L. No. 111-148) (ACA), as amended by the Health Care and Education Reconciliation Act of 2010 (enacted March 30, 2010, Pub. L. No. 111-152), codified as amended in various sections of Title 26 (the Internal Revenue Code) and Title 42 (Public Health and Welfare) of the U.S. Code.
- ² The ACA establishes the Exchange as a marketplace where individuals may shop for and purchase QHP coverage. The Exchange operates in each state and may be established and administered by the state, or established and administered on behalf of the state by the Department of Health and Human Services (HHS).
- ³ See section 1341 of the ACA.
- ⁴ See section 1342 of the ACA.
- ⁵ See section 1343 of the ACA.
- ⁶ The required payments to the programs are described as "contributions" in the program literature, but are referred to as "assessments" or "payables" in this article to be consistent with the terminology used in SSAP No. 107. Amounts redistributed by the programs back to reporting entities are described as "payments" in the program literature, but are referred to as "distributions" or "receivables" in this article and in SSAP No. 107.
- ⁷ The IRS has posted a FAQ on its website regarding the Transitional Reinsurance program, which indicates that "[h]ealth insurance issuers will be able to treat contributions under the Reinsurance Program as ordinary and necessary expenses paid or incurred in carrying on a trade or business ... or as a reduction to taxable income as provided under Subchapter L." See <http://www.irs.gov/uac/Newsroom/ACA-Section-1341-Transitional-Reinsurance-Program-FAQs>.
- ⁸ Section 1251 of the ACA provides that certain group health plans and health insurance coverage existing on March 23, 2010 (the date of enactment) that continue to satisfy requirements set forth in regulations issued by the Departments of Treasury, Labor and HHS are considered "grandfathered" health plans and are not subject to certain ACA requirements.
- ⁹ On Jan. 26, 2015, the state of Ohio filed suit against the United States, specifically HHS, challenging the constitutionality of the imposition of the transitional reinsurance assessment against state and local governments that provide employees with health insurance through self-insured group health plans. See *State of Ohio et al v. U.S.*, et al, docketed at 15-cv-0321 (S.D. OH).
- ¹⁰ HHS has the authority to administer the Transitional Reinsurance program fee. Although HHS' authority to impose penalties on covered entities for failure to pay the fee is not entirely clear, section 1321(c) of the ACA (via a cross-reference to section 2736(b) of the Public Health Service Act) can be read to provide HHS with penalty authority with respect to the establishment of the Transitional Reinsurance program. Penalties under section 2736(b) of the Public Health Service Act are up to \$100 per day per affected individual.
- ¹¹ The assessed amounts will provide a reinsurance pool of \$10 billion for the 2014 coverage year, \$6 billion for the 2015 coverage year and \$4 billion for the 2016 coverage year.
- ¹² The administrative expense is estimated to be \$20.3 million for the 2014 coverage year. HHS is organizing and operating the reinsurance entities for all states but one.
- ¹³ The contribution to the U.S. Treasury will be \$2 billion for both 2014 and 2015, and \$1 billion for 2016.
- ¹⁴ For the 2015 coverage year, the reinsurance assessment will be \$44 per enrollee, of which \$33 per enrollee must be paid by Jan. 15, 2016, with the balance due no later than Nov. 15, 2016. For the 2016 coverage year, the reinsurance assessment is set at \$27 per enrollee, with \$21.60 per enrollee due no later than Jan. 15, 2017, and the remaining \$5.40 per enrollee due no later than Nov. 15, 2017.
- ¹⁵ For the 2015 coverage year, the coinsurance rate is 50%, the attachment point remains at \$45,000 and the cap remains at \$250,000. For the 2016 coverage year, HHS has proposed a coinsurance rate of 50 percent, an attachment point of \$90,000 and a cap of \$250,000.
- ¹⁶ See, for example, Treas. Reg. §1.832-4(a)(4)(i) and Revenue Ruling 77-453.
- ¹⁷ For purposes of this discussion of the Risk Corridor program, QHPs means policies and plans offered on the Exchange and policies and plans offered on the individual or small group market that are substantially similar to the QHPs.
- ¹⁸ For a QHP, "allowable costs" is composed of the sum of incurred claims of the QHP issuer, adjusted to include qualifying expenditures by the QHP for activities that improve health care quality, expenditures for health information technology, and meaningful use requirements and other required adjustments.
- ¹⁹ The "target amount" is equal to the total premiums earned with respect to a QHP, including any premium tax credit under any governmental program, reduced by the allowable administrative costs of the plan.
- ²⁰ For a QHP, "allowable administrative costs" consist of the sum of (1) administrative costs of the QHP, other than taxes and regulatory fees, plus (2) profits earned by the QHP, but as limited to the sum of 20 percent and the adjustment percentage of after-tax premiums earned with respect to the QHP (including any premium tax credit under any governmental program), plus (3) taxes and regulatory fees. The adjustment percentage for the 2014 coverage year is zero; for the 2015 coverage year it is 2 percent.
- ²¹ If the QHP's allowable costs for a coverage year are more than 103 percent but not more than 108 percent of the target amount, the QHP issuer is entitled to receive an amount equal to 50 percent of the allowable costs in excess of 103 percent of the target amount. If the QHP's allowable costs are more than 108 percent of the target amount, the QHP issuer is entitled to receive an amount equal to the sum of 2.5 percent of the target amount, plus 80 percent of the allowable costs in excess of 108 percent of the target amount.
- ²² If the QHP's allowable costs for a coverage year are less than 97 percent but not less than 92 percent of the target amount, the QHP issuer is required to pay HHS an amount equal to 50 percent of the excess of 97 percent of the target amount over the allowable costs. If the QHP's allowable costs are less than 92 percent of the target amount, the QHP issuer is required to pay HHS an amount equal to the sum of 2.5 percent of the target amount, plus 80 percent of the excess of 92 percent of the target amount over the allowable costs.
- ²³ The official title of the CRomnibus legislation is the "Consolidated and Further Continuing Appropriations Act, 2015," H.R. 83.
- ²⁴ For the 2014 and 2015 coverage years, the rate is \$.08 per insured per month.

THE SECOND EDITION OF *LIFE INSURANCE & MODIFIED ENDOWMENTS UNDER INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A*

by John T. Adney, Brian G. King, and Craig R. Springfield

In the fall of 2002, our colleague and friend, the late Chris DesRochers, observed that the IRS had not finalized a single regulation, and had published very little other authority, to provide guidance on the tax statutes defining life insurance and modified endowment contracts, sections 7702 and 7702A of the Internal Revenue Code.¹ This was the case even though the two statutes then were, respectively, 18 and 14 years old, and section 7702's predecessor defining flexible premium life insurance contracts, section 101(f), had then been on the planet for two decades. So, Chris proposed the SOA should publish a textbook to fill in the gap, educating life insurance product designers and tax practitioners on the subject. To join in the writing, Chris recruited two actuaries, Douglas Hertz and Brian King, and one lawyer, John T. Adney, all of whom claimed to be conversant with the statutes. (The lawyer clearly was outnumbered.)

Two years later, when the first edition of *Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A*—or “LIME” for short, as the textbook was nicknamed by actuarial students—first appeared in print, still no final regulation existed under the statutes, and aside from a 2003 revenue ruling intended to address the “recapture ceiling” rules² using an example that turned out to describe a MEC,³ very little authority provided guidance. True, more and more private letter rulings concerning sections 101(f) and 7702 became public, but these did not constitute authority insurers could rely on, and they mostly dealt with insurers' self-confessed failures to comply with those Code sections. And so insurers' product designers and administrators, and the tax practitioners who looked over their shoulders, began reading *LIME* for instruction and perspective, however unofficial the book was. The book also found its way to the IRS and the Treasury Department, and the IRS saw fit to cite it in a private letter ruling.

Even as the printing press produced the initial copies of *LIME* in the fall of 2004, significant change was setting in for life

product taxation. The textbook had been drafted when the 1980 CSO Tables governed product filings and “reasonable mortality” in the section 7702 and 7702A testing, and so it contained numerous illustrations based on 1980 table mortality, but the 2001 CSO Tables were rapidly becoming the new standard. In 2004, the remediation of inadvertent noncompliance with the section 7702A rules was still relatively new, and remediation of life insurance definition failures continued to labor under the yoke of a 1991 revenue ruling and the largely undefined “reasonable error” standard of the statute.⁴ By 2008, the IRS precipitated a “remediation revolution” with its publication of a series of revenue procedures intended to streamline the restoration of contracts to compliant status. The IRS also took the step of finalizing a substantive regulation under the statutes, defining what was meant by an insured's “age.” And in 2004 the insurance industry was just getting around to recognizing the potential usefulness of accelerated death benefit riders, for which Congress had cleared the path in the 1996 HIPPA legislation.⁵ Perhaps most importantly for the future of product tax compliance, while the textbook had been drafted with practitioners (seasoned or not) in mind, the SOA began using it as course material for students seeking the FSA credential.⁶

So when the supply of *LIME* books in the SOA's warehouse became small, Chris was asked to consider a revision of the text to reflect the changing circumstances, with particular focus on the needs of actuarial students. With the retirement of Doug Hertz, Chris turned to the three co-authors of this article to join him in producing *Life Insurance & Modified Endowments 2nd Edition*, which we naturally call *LIME 2*. Not long after preparation for the new edition began under Chris's guidance in 2013, tragedy struck with his sudden and untimely death. But in the fall of that year, the three of us resolved to push forward with production of a greatly revised text, not least as a means of honoring Chris's memory. Fittingly, his name remains on the second edition, as the lead author, since it was all his idea in the first place. Chris in fact



CONTINUED ON PAGE 40

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

Brian G. King is an executive director at Ernst & Young LLP and may be reached at brian.king3@ey.com.

Craig R. Springfield is a partner in the Washington, D.C. law firm of Davis & Harman LLP and may be reached at crspringfield@davis-harman.com.

laid the groundwork for the book's new structure and its newly formed initial chapters before his passing.

LIME 2, when it is published this fall, will therefore have a new look as well as fully updated content. The second edition will begin with two chapters that provide a relatively succinct summary of all of the section 7702 and 7702A rules (and some section 101(f) rules) that actuarial students, and perhaps other students, need to know about the statutes. In doing so, Chapters 1 and 2 provide basic instruction on the calculations under the cash value accumulation test (CVAT) and guideline premium test (GPT) as well as the 7-pay test; guidance on identification of the interest, mortality, and expense assumptions to be employed in the calculations; insight into the meaning of the "applicable law" rule that first greets the reader of section 7702; a summary of other life insurance tax rules; and some useful background on how the statutes came to be. Also, Chapter 2 (like its later counterparts) provides numerous illustrations based on the 2001 CSO Tables and discusses in detail the IRS's guidance on the reasonable mortality rules. The initial two chapters, then, serve as a fairly comprehensive tour of the statutes for novitiates, albeit omitting (perhaps mercifully) the details of the adjustment, material change, necessary premium, and remediation rules.

The third chapter fills in other fundamental information that is more of interest to practitioners, such as the evolving definition of "cash surrender value" under section 7702, the (sole) regulation's direction on determining an insured's age, the limitations imposed and opportunities presented by the primary and alternate computational rules, considerations in performing post-age-100 and substandard mortality calculations, and the rules for reflecting "qualified additional benefits" (QAB) in the statutory premium limits. Chapter 3 thus details the history of the IRS's ruling position on the meaning of cash value under the life insurance definition, followed by an exploration of the rules and scope of the regulation defining age. It then proceeds to unpack the computational rules and differentiate the ways they apply under the two tests of section 7702 and under the MEC definition. The chapter concludes with a discussion of the QAB rules and the treatment of additional term insurance covering the primary life insured under a contract.

The mysteries of the so-called adjustment rules of the statutes, and the even greater mysteries of the Code's general material

change rules as they may apply to life insurance contracts, are the subjects, respectively, of Chapters 4 and 5 of *LIME 2*. Chapter 4 describes the manner in which the section 7702(f)(7)(A) adjustment provisions apply under the CVAT and apply differently under the GPT, and it also lays out the reduction-in-benefit and material change rules of section 7702A(c)(2) and (3), providing updated illustrations of their application. New in this chapter is an expanded discussion of the "necessary premium test" embedded in section 7702A(c)(3), a challenging concept that has been the focus of insurers' programming efforts in recent years. Chapter 5 undertakes a highly detailed treatment of material changes in the broad sense of the tax law, examining a set of authorities that, where applicable, can significantly disrupt insurers' efforts to comply with the statutory limitations by forfeiting "grandfathering" of pre-existing rules.

Chapter 6 in the original version of *LIME* addressed the manner in which sections 7702 and 7702A apply to special products and special features of products, and Chapter 6 of the second edition continues and elaborates on these topics. New in this chapter are discussions of guaranteed minimum withdrawal benefits under variable contracts, equity-indexed contracts, and no-lapse guarantees, along with enhanced discussion of cash value bonuses, return-of-premium benefits, and pre-need contracts.

A completely new chapter, Chapter 7, is included in *LIME 2* to provide a robust treatment of accelerated death benefits, covering qualified long-term care insurance riders subject to the section 7702B rules and chronic and terminal illness riders governed by section 101(g). This is followed by the completely revamped chapter on the remediation of contracts that do not comply with the definitional limitations, Chapter 8. The series of revenue procedures that the IRS issued in 2008 are described and discussed in detail in this chapter. The new book's two concluding chapters carry forward, with updating, the messages of the original book's final chapters. Chapter 9 reviews the history of the development of the definition of life insurance under the federal tax law as well as the events leading to the enactment of the MEC rules, and Chapter 10 considers the federal tax policy premises and implications for the definitional statutes.

LIME 2 retains the valuable appendix matter of the original text, providing reprints of the statutes themselves

(expanded to cover accelerated death benefits) and the important legislative history materials that have been key to the IRS's interpretation and the industry's understanding of sections 7702 and 7702A. Also retained and expanded is the book's glossary of terms.

The co-authors of *LIME 2* would be remiss in not mentioning the support they have enjoyed in their re-write of the book from SOA staff, experienced individuals in the insurance industry who served as peer reviewers, and their own professional colleagues (not to mention some very tolerant family members). Acknowledgement of those providing such support, naming names, will appear at the front of the new text. We look forward to seeing the second edition in print, and we hope it will serve the interests of its readers for years to come. ◀

END NOTES

- ¹ References to section are to sections of the Internal Revenue Code of 1986, as amended (Code).
- ² The ruling was Rev. Rul. 2003-95, 2003-2 C.B. 358, relating to the rules of IRC § 7702(f)(7)(B)-(E).
- ³ That is, a modified endowment contract within the meaning of IRC § 7702A(a).
- ⁴ Rev. Rul. 91-17, 1990-1 C.B. 190; IRC §§ 101(f)(3)(H) and 7702(f)(8) (providing for waiver of noncompliance in the case of reasonable error).
- ⁵ The Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, added to the Code IRC §§ 101(g) and 7702B.
- ⁶ So far, law students have not needed to master the statutes to satisfy bar examiners, and those seeking the CPA designation appear equally safe.

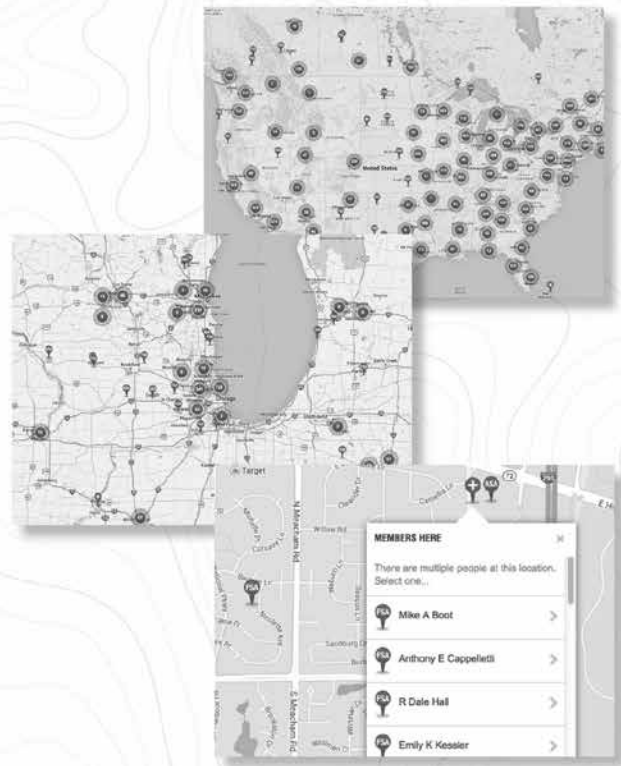
SOCIETY OF ACTUARIES

SOA EXPLORER TOOL

Find fellow actuaries around the block or around the globe

The newly-created SOA Explorer Tool is a global map showing you where SOA members, their employers and actuarial universities are located.

To use the SOA Explorer Tool, visit soa.org and sign in as a member.





ACLI UPDATE

By Pete Bautz and Mandana Parsazad

Pete Bautz is vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at petebautz@acli.com.

Mandana Parsazad is senior counsel, Taxes & Retirement Security, at ACLI in Washington, D.C. and may be reached at mandanaparsazad@acli.com.

The National Commissioners Association of Insurance Commissioners (NAIC) approved the 2012 Individual Annuity Reserve table (2012 IAR Table, or the Table) as the standard for computing reserves for individual annuity contracts and developed a model regulation (NAIC Model 821) for states to adopt. The Table introduces the use of a generational structure (which generally calculates different life expectancies based on year of birth) into the computation of individual annuity reserves. The 2012 IAR Table generally will result in higher reserves, making it more expensive for a company to write payout annuities when the Table is required for use by the company's domestic state.

Subsequently, the states began to adopt the 2012 IAR Table through regulations that permit the use of the Table for computing reserves for individual annuity contracts, effective Jan. 1, 2015. On Dec. 24, 2014, the total number of states that had adopted the 2012 IAR Table as the reserve standard for future new immediate annuity contracts as defined in NAIC Model 821 reached the threshold of 26 required by section 807(d)(5)(A) of the Internal Revenue Code (the Code).

On February 17, ACLI submitted a letter to Alexis MacIvor, chief of the Insurance Branch in the IRS Office of Chief Counsel, notifying her that as of Dec. 24, 2014, 26 states had approved the 2012 IAR Table as the reserve standard for immediate annuity contracts issued on or after Jan. 1, 2015. The letter thus confirms that the 2012 IAR Table is the Prevailing Commissioners' Standard Table for purposes of computing life insurance reserves under section 807(d) of the Code for individual annuity contracts.

Section 807(d)(5)(B) of the Code permits insurers to use the preceding prevailing tables for a three-year transition period, after which the use of the new prevailing tables becomes mandatory for computing life insurance reserves. The use of the 2012 IAR Table will thus become mandatory for new business issued on or after Jan. 1, 2018. ◀

T³: TAXING TIMES TIDBITS



IRS CONCLUDES IN CCA THAT SECTION 197 APPLIES TO ALL SECTION 1060 INDEMNITY REINSURANCE TRANSACTIONS

By Lori J. Jones

In an interesting start to the new year, the Internal Revenue Service (IRS) released guidance which concluded that section 197¹ requires the capitalization and amortization of a ceding commission in excess of the amount capitalized under section 848 in “any” section 1060 transaction involving an insurance business. Section 197(f)(5) provides rules to determine the amount of an amortizable section 197 intangible resulting from an assumption reinsurance transaction. In Chief Counsel Advice (CCA) 201501011 (Sept. 4, 2014), the IRS concluded that section 197 applies to a ceding commission regardless of whether the transfer of the insurance business occurs pursuant to an underlying assumption reinsurance or indemnity reinsurance transaction. When the regulations under sections 338 and 1060 were being finalized in 2006, commentators asked for clarification that a ceding commission is deductible under section 848(g) in an indemnity reinsurance transaction even if the overall transaction is subject to section 1060. The clarification was not made and no explicit clarification (supporting either conclusion) was included at that time.² It is unfortunate that the guidance on this significant issue is being offered by the IRS only in the form of a CCA. Moreover, the analysis set forth in the CCA raises questions as to its validity.

Summary of Facts

In the CCA, the parties entered into a Master Asset Purchase Agreement (Agreement) whereby Taxpayer purchased certain assets used in Seller’s life reinsurance business, including workforce in place and certain fixed assets. The parties also entered into a retrocession agreement for a specified number of Seller’s life reinsurance contracts. The Agreement recital provided that Taxpayer wished to assume this portion of Seller’s business on a 100-percent coinsurance indemnity basis and that Seller also would enter into an Assumption Agreement whereby Seller agreed to use commercially reasonable efforts to ensure that Taxpayer assumed, on a novation basis, each of

the life reinsurance agreements. The facts state that, by Date 2, a certain percentage of the retroceded contracts had been novated to Taxpayer, and, by Date 3, all of the contracts were novated. The actual dates and their proximity in time are not identified in the redacted version of the CCA.

Taxpayer treated the transaction as indemnity reinsurance under SSAP 61 and stated that the transaction was a section 1060 applicable asset acquisition. For federal income tax purposes, Taxpayer deducted the amount of the ceding commission in excess of the amount capitalized under section 848 because in Tax Year 1 Seller remained liable to the original ceding companies. None of the novations were completed before Date 4. (This suggests that Date 4 is before Date 2.) Consequently, in that case, Taxpayer argued that section 197(f)(5) did not apply and the ceding commission in excess of the amount required to be capitalized under section 848 was fully deductible under section 848(g) (which provides that no rule other than section 848 or 197 requires the capitalization of any ceding commission).

The IRS relied on two arguments to support its conclusion. The first was that the overall transaction was in substance an assumption reinsurance agreement to which section 197 applied even though it was initially structured as an indemnity reinsurance agreement. The second was that section 197 requires capitalization of any ceding commission without regard to whether the underlying reinsurance itself is assumption or indemnity reinsurance if the overall transaction qualifies under section 1060, i.e., there is reinsurance as well as an applicable asset acquisition.³

CCA: The Transaction Should Be Treated as Assumption Reinsurance

The IRS noted that, even though the Agreement recital supported Taxpayer’s position that the retrocession was on a 100-percent indemnity coinsurance basis, the contract as a whole included language of an assumption reinsurance agreement. As a result, the CCA held that there were sufficient facts to conclude the Agreement was an “assumption retrocession” contract.⁴ The IRS relied on the fact that the Entire Agreement

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at ljones@scribnerhall.com.

CONTINUED ON PAGE 44

incorporated the Assumption and Novation Agreements and the Agreement indicated Seller's intent to sell and exit the life reinsurance business.

Treas. Reg. § 1.197-2(g)(5) contains rules on the treatment of certain insurance contracts acquired in an assumption reinsurance transaction. The regulations apply to:

- assumption reinsurance which is defined in Treas. Reg. § 1.809-5(a)(7)(ii) as, "an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of section 1.809-4);"
- the transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company which is treated as an assumption reinsurance transaction; and
- the transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) that is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction.

In the CCA, at the time the ceding commission was paid, the relevant agreement was the indemnity reinsurance agreement and Seller had continuing obligations to the ceding companies.

By treating the overall transaction as an assumption reinsurance agreement subject to section 197(f)(5) in Year 1, the IRS appears to rely on the step-transaction doctrine. No authority is cited in the CCA. The IRS could have relied on the last category in the regulation described above, i.e., the transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction, since it treated all parts of the transaction as one.

In the context of retrocessions, the CCA's application of the step-transaction doctrine may have some merit where extinguishments of the original ceding company's obligations to the direct writer are forthcoming and previously negotiated. Extension of the CCA's analysis to indemnity reinsurance where approval of policyholders to a novation of the direct

writer's obligation is required would be troublesome and result in uncertainty without further guidance. It is difficult to see how the step-transaction doctrine can apply where the second step (contract novation) is dependent on multiple third-party consents.

CCA: Section 197 Applies to Indemnity Reinsurance in a Section 1060 Transaction

The more troubling analysis is the conclusion that section 197 applies to any section 1060 transaction even if the underlying reinsurance is indemnity reinsurance. The IRS appears to be adopting a much broader approach to the application of section 197(f)(5) and one which is outside the authority of both the statute and the regulations.⁵ The CCA states that Taxpayer failed to address why the regulations under sections 1060, 338 and 197 did not apply to the transaction. It then states that, "If they do, whether Taxpayer entered an assumption or indemnity arrangement with Seller does not determine how it treats the ceding commission for federal income tax purposes (and precludes consideration of whether Arrangement is an assumption or indemnity retrocession contract)." The CCA further concludes that it is "clear" in the residual method rules that an indemnity reinsurance contract is a Class VI asset, section 197 intangible, and it is "clear" the residual method rules treat section 338 and 1060 acquisitions as deemed assumption reinsurance arrangements. The CCA then concludes that, because the section 338 regulations treat the deemed sale of insurance contracts as an assumption reinsurance transaction for federal income tax purposes, and the regulations apply to section 1060 acquisitions, a "section 1060 acquisition is likewise treated as an assumption reinsurance transaction." In conclusion, the CCA holds that Taxpayer must capitalize under section 197 the portion of the ceding commission in excess of the amount capitalized under the DAC provisions.

The IRS' conclusion ignores the basic reason for the limitation of section 197(f)(5) to assumption reinsurance transactions in the first place. An assumption reinsurance transaction results in the transfer of all the value of an intangible asset—the insurance in force. Thus, it makes sense to amortize any ceding commission paid in an assumption reinsurance transaction pursuant to section 197(f)(5). In contrast, an indemnity reinsurance transaction typically is not a permanent transfer of the same intangible asset. Instead, the intangible asset acquired by the reinsurer is merely the contractual rights under the reinsurance contract. The different nature of the intangible asset acquired is reflected by the fact that the direct obligation to

the policyholders remains with the ceding company whereas that obligation is extinguished in the context of assumption reinsurance, and the indemnity reinsurance agreement often contains recapture provisions that allow the agreement to be terminated, thus having the effect of transferring the business back to the ceding company.

The general rule in Treas. Reg. § 1.197-2(g)(5)(i) (set forth above) contains no cross-reference to the section 1060 regulations. In fact, by referring to the definition of assumption reinsurance in Treas. Reg. § 1.809-5(a)(7)(ii), the section 197 regulations exclude indemnity reinsurance from the scope of section 197(f)(5) with no mention of the exclusion being limited to those ceding commissions that are *not* acquired or paid in connection with a transaction to which the section 1060 allocation rules apply. Further, the reference in the section 197 regulations to an acquisition in connection with a section 338 election should not be read to include transactions which do not involve an actual section 338 election such as those subject to section 1060. The CCA makes the puzzling suggestion that the legislative history to section 197(f)(5) expresses a Congressional intent that indemnity reinsurance acquired in a section 338 asset acquisition could be a section 197 intangible. It is difficult to see how indemnity reinsurance would be used in a section 338 fictional deemed asset sale.

Moreover, section 1060 contains special allocation rules for certain asset acquisitions and Treas. Reg. § 1.1060-1(c) only provides a rule for the allocation of consideration among assets. Treas. Reg. § 1.1060-1(c)(5) applies to the acquisition under section 1060 of an insurance business and states that the section 1060 rules are modified by the principles of § 1.338-11(a) through (d) (which provide that if a target is an insurance company, the deemed sale of insurance contracts is treated for Federal income tax purposes as an assumption reinsurance transaction.) These principles apply only in the context of section 1060 for purposes of determining the amount allocable to the insurance contracts and do not govern whether section 197 applies to the overall transaction.

The reference to the section 338 regulations in Treas. Reg. § 1.1060-1(c)(5) only applies to determine the proper allocation of consideration among the acquired assets and does not address whether any portion of the ceding commission is subject to section 197, as assumed in the CCA. Section 197(f)(5) requires capitalization in the case of assumption reinsurance transactions. Treas. Reg. § 1.197-2(g)(5)(ii)(B) states that the amount paid or incurred by a reinsurer *under*

an assumption reinsurance transaction includes the amount allocated under section 1060. Thus, section 197 and the regulations require that the transaction be an assumption reinsurance transaction first. This is consistent with the statement in the Notice of Proposed Rulemaking that added Treas. Reg. § 1.1060-1(c)(5) which stated: “the rules in the proposed regulations under section 197 also apply to reinsurers of insurance business in transactions governed by section 1060 if effected through assumption reinsurance.” REG-118861-00 (Mar. 8, 2002), 2002-1 C.B. 651.

Finally, contrary to the CCA’s assertion, it is not clear that a Class VI asset is always a section 197 intangible. Treas. Reg. § 1.338-6(b)(2)(vi) states that Class VI assets are “all section 197 intangibles, as defined in section 197, except goodwill and going concern value.” Treas. Reg. § 1.1060-1(c)(5) implicitly provides an exception to this rule and states that, “. . . in transactions governed by section 1060, such principles apply even if the transfer of the trade or business is effected in whole or in part through indemnity reinsurance rather than assumption reinsurance, and, for the insurer or reinsurer, an insurance contract (including an annuity or reinsurance contract) is a Class VI asset *regardless of whether it is a section 197 intangible.*” (Emphasis added). This language only makes sense if it is possible that the ceding commission in a section 1060 indemnity reinsurance transaction may not always be a payment for a section 197 intangible. Second, the CCA is incorrect in stating it is “clear” that the residual method rules treat section 338 and 1060 transactions as deemed assumption reinsurance arrangements for all purposes. As noted above, the application of the deemed assumption reinsurance rules only affects the allocation of consideration among assets under section 1060. The CCA is not relying on either section 848 or 197 to impose capitalization, but rather on section 1060—a questionable conclusion.

In conclusion, the CCA raises numerous questions as to whether it is appropriate to capitalize a ceding commission under section 197(f)(5) in the context of an indemnity reinsurance transaction merely because the transaction is otherwise subject to section 1060. ◀

CONTINUED ON PAGE 46

END NOTES

- ¹ References to section are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
- ² The preamble states that, "Commentators asked that the final regulations clarify that the full amount of consideration allocable to the reinsured contracts is currently deductible under section 848(g) when the provisions of section 848 apply to an indemnity reinsurance transaction that occurs as part of a section 1060 acquisition of an insurance business." T.D. 9257 (April 10, 2006).
- ³ Treas. Reg. § 1.1060-1(b)(9) states that, "The mere reinsurance of insurance contracts by an insurance company is not an applicable asset acquisition, even if it enables the reinsurer to establish a customer relationship with the owners of the reinsured contracts. However, a transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach. For rules regarding the treatment of an applicable asset acquisition of an insurance business, see paragraph (c) (5) of this section."
- ⁴ The CCA includes a footnote which states that the IRS position is that a retrocession agreement is treated as reinsurance citing Rev. Rul. 2008-15, 2008-1 C.B. 633, but noting the contrary conclusion in *Validus Reinsurance, Ltd. v. U.S.*, 19 F. Supp. 3d 225 (D.D.C. 2014) 2014-1 U.S. Tax Cas. (CCH) P70 325.
- ⁵ The 1993 legislative history to section 197(f)(5) states as follows: The bill applies to any insurance contract that is acquired from another person through an *assumption reinsurance transaction* (but not through an *indemnity reinsurance transaction*). The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the *assumption reinsurance transaction*, over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the *assumption reinsurance transaction*. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an *assumption reinsurance transaction* is to be amortized over the period specified in section 848 of the Code. H.R. Rep. No. 103-213, at 687-88 (1993) (Conf. Rep.) *Assumption reinsurance* as defined in the legislative history is, "An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an *assumption reinsurance transaction* is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code." (Emphasis added.) H.R. Rep. No. 103-213, at 974 n. 125 (1993) (Conf. Rep.).

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at ljones@scribnerhall.com.

TWO PLRs PROVIDE SOME CLARITY ON SECTION 351 AND INDEMNITY REINSURANCE

By Lori J. Jones

Twenty years after the Internal Revenue Service (IRS) changed its position on the application of section 351 to assumption reinsurance transactions in Rev. Rul. 94-45, 1994-2 C.B. 39, through the issuance of two private letter rulings, we have some clarity on the corollary question of whether section 351 can also apply to indemnity reinsurance transactions even if novations are not expected as part of the overall transaction. The bottom line is that, if the indemnity reinsurance transaction is of a permanent nature, the IRS has concluded that section 351 can apply so that the ceding commission is not subject to tax pursuant to subchapter L (assuming all of the other section 351 requirements are satisfied). However, if the indemnity reinsurance agreement permits recapture by the ceding company or includes profit sharing provisions, the principles of subchapter L will apply to determine the proper tax treatment of the arm's length reinsurance portion of the transaction.

Section 351 provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock and immediately after the exchange such person(s) are in control of the corporation. In Rev. Rul. 94-45, the IRS held that the transfer of assets to a subsidiary which included the transfer of the insurance business via assumption reinsurance was tax-free under section 351. In that case, the ceding company was not subject to tax on the transfer of the insurance in force which was included in the value of the stock received in the exchange. If the reinsurance portion of the transfer is carved out of the section 351 transaction and treated as a taxable transaction, the results can be very different (e.g., increases/decreases in tax reserves, DAC, etc.)

PLR 201506008

In February, the IRS released PLR 201506008 (Oct. 21, 2014), which applied section 351 to an indemnity reinsurance transaction that the IRS stated was anticipated to result in a permanent transfer. (The ruling initially had been submitted to the IRS in June 2012, and, therefore, was not subject to the restrictions on section 351 rulings initially imposed by the Corporate Division in Rev. Proc. 2013-32, 2013-28 I.R.B. 55.) The proposed transaction involved the transfer of assets to a newly acquired dormant shell insurance company (Corporation C). Corporation C will be owned by newly formed Partnership B

(an LLC), which will in turn be owned by Partnership A (also an LLC). Partnership A also owns Corporation A, an insurance company for federal income tax purposes that operates as a direct writer and reinsurer of dental, life and health insurance contracts in most states. Partnership A was formed to provide a joint venture for Branded Insurers and their subsidiaries and to combine certain components of their dental, life and health business.

In the transaction, Partnership A will form Partnership B and Partnership B will acquire the stock of Corporation C. Partnership A will then contribute cash, and Corporation A and New Investors (who will acquire an interest in Partnership A) will contribute a certain percentage of their Specified Line of Business, to Corporation C solely in exchange for stock. Specifically, the contribution by Corporation A and New Investors will include insurance in force via reinsurance contracts, and a contract transferring the rights to perform administrative services for the business currently managed by New Investors (New ASC). Also in exchange for stock, Corporation A and the New Investors will contribute all existing unpaid Specified Line of Business liabilities (i.e., claims and IBNR liabilities) and related assets. The transferred assets will include cash, investment assets, and premium receivables, as well as the right to then future results of the future insurance policies for existing and future customers of Corporation A and New Investors. Corporation A also will transfer employees to Corporation C to perform certain functions relating to the business. After the contributions and pursuant to a pre-existing binding plan, Partnership A, Corporation A, and New Investors will contribute their Corporation C stock to Partnership B in exchange for Partnership B units.

The PLR also states that the transfer of the Specified Line of Business will be effected by a “100 percent coinsurance agreement written on an indemnity basis, with automatic reinsurance on new policies directly written on a going forward basis.” The PLR specifically states:

The reinsurance agreement will only be in exchange for a transfer of Corporation C shares, which represent a long-term continuing interest in Corporation C. There will be no experience rated refunds or profit sharing provisions to the reinsurance agreement. Should Corporation A or New Investors decide to withdraw from the joint venture, they would be required to purchase the Specified Line of Business it contributed back from Corporation C at fair market value including a gross up for taxes. **As a result, it**

is anticipated that the transfer under the reinsurance agreement will be permanent. (Emphasis added.)

The New Investors will retain the actual subscriber, provider and underlying administrative services contracts and operate on a fronting basis via the indemnity reinsurance. It is also anticipated that Corporation C will operate via a transitional services agreement with New Investors until Corporation C has the infrastructure to manage the administration of the insurance business.

The IRS concluded that the transfer of assets by the Corporation C shareholders, including reinsurance contracts and new ASC, in exchange for Corporation C stock, constitutes a transfer of property to a controlled corporation meeting the requirements of section 351. Consequently, the IRS ruled that no gain or loss will be recognized by the shareholders on the transfer of the assets, including the Specified Line of Business, in exchange for stock. The IRS did not cite Rev. Rul. 94-45 as support for their conclusions.² It did require several typical representations from the taxpayer, including a representation that a portion of the fair market value of the stock to be issued is allocable to the value of the insurance in force and that Corporation C would be solvent immediately after the contributions. Similarly, the taxpayer represented that the total fair market value of the transferred assets will exceed the amount of any liabilities assumed (within the meaning of section 357(d) and taking into account the application of Rev. Rul. 80-323, 1980-2 C.B. 124) by Corporation C in connection with the exchange. (Rev. Rul. 80-323 holds that each partnership interest exchanged for Newco stock will be transferred subject to its share of partnership liabilities and gain will be recognized to the extent that each partner’s share exceeds the adjusted basis of the interest transferred.) Most other representations were those required by Rev. Proc. 83-59, 1983-2 C.B. 575, which are/were applicable to section 351 transactions in general.

PLR 201511015

The IRS reached a different conclusion in PLR 201511015 (Nov. 14, 2014), where it held that the tax treatment of the transfer of assets and liabilities in the arm’s-length reinsurance portion of a proposed transaction would be determined in accordance with the provisions of subchapter L applicable to indemnity reinsurance. (By contrast to PLR 201506008, this PLR was subject to the restrictions in Rev. Proc. 2013-32, *supra*.) The IRS also stated that the application of subchapter

CONTINUED ON **PAGE 48**

L to the reinsurance portion did not preclude the transfer of other assets in excess of the arm's-length reinsurance portion of the proposed transaction from qualifying under section 351. Thus, the IRS appeared to take the same approach here that it took in PLR 201006002 (Nov. 6, 2009) (where the arm's-length transfer of assets and liabilities in an indemnity reinsurance transaction were not subject to section 351, but the transfer of additional assets did qualify for section 351 treatment).

The proposed transaction in PLR 201511015 involves a Parent corporation that was the common parent of a life/nonlife consolidated return which includes LifeCo, a life insurance company for federal income tax purposes. LifeCo had previously demutualized and became a stock company now owned indirectly by Parent. Certain LifeCo policies in force at the time of its demutualization became a closed block of contracts entitled to receive policyholder dividends and LifeCo designated certain assets to support the regulatory closed block of policies (the RCB). The designated RCB assets are not kept in an account separate from LifeCo's other assets.

In the proposed transaction, LifeCo and Sub will enter into a Reinsurance Agreement. Sub will either be a newly formed corporation of LifeCo or an existing wholly owned corporation of LifeCo that is part of the life insurance company subgroup of the Parent consolidated group. LifeCo will transfer capital and surplus as well as assets and liabilities related to the RCB to Sub. It is represented that the fair market value of the assets that will be transferred to Sub will exceed the amount of assets that LifeCo would be required to pay in an arm's-length indemnity reinsurance transaction. The reinsurance transaction is described as follows:

Pursuant to the Agreement, LifeCo will cede and Sub will assume certain specified liabilities. LifeCo will transfer approximately d percent, which is less than 100 percent, of the insurance risk on the RCB business to Sub by conventional coinsurance on the Effective Date. **Moreover, the Agreement provides LifeCo with recapture rights. At any time, LifeCo may elect to recapture, in full or in part, the reinsurance coverage provided by the Sub. If LifeCo elects to exercise such rights, the Sub is obligated to return any remaining RCB assets to LifeCo.** (Emphasis added.)

Key Differences

It is this last emphasized language in PLR 201511015 that provides a stark contrast to the facts stated in PLR 201506008,

and which likely resulted in a different conclusion. Another factual difference is that PLR 201506008 did not involve a transaction between two members of the same consolidated group (as was the case in PLR 201511015). No analysis is provided in either PLR, but the key difference appears to be that in order for the transfer of assets and liabilities in an indemnity reinsurance transaction to qualify under section 351, the transfer must be "permanent." This conclusion is consistent with the IRS view that there is no transfer of intangible property unless all substantial rights in the property are transferred by the transferor corporation. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101.³ The conclusion is also consistent with Treas. Reg. section 1.197-2(g)(5)(iii), which provides guidance on the loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction. The regulation provides that the loss may be taken as a result of an indemnity reinsurance transaction, "provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer." Treas. Reg. section 1.197-2(g)(5)(iii)(A). The regulation also states that:

However, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if it has a right to experience refunds reflecting a significant portion of the future profits on the reinsured contracts . . . through the exercise of a recapture provision. In addition, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if the reinsurer assumes only a limited portion of the ceding company's risk relating to the reinsured contracts (excess loss reinsurance).

In PLR 201506008, the taxpayer represented that there will be no experience rated refunds or profit sharing provisions to the reinsurance agreement and that a fair market value purchase price (including a gross up for taxes) would be required should the investors seek to repurchase the transferred business. In contrast, in PLR 201511015, the indemnity reinsurance agreement will provide the ceding company with recapture rights. It is not clear whether the IRS conclusion in PLR 201511015 was also based on the fact that less than 100 percent of the risk was transferred. Such a conclusion might be consistent with the last sentence in Treas. Reg. section 1.197-2(g)(5)(iii)(A)(2), i.e., that the reinsurer assumed only a limited portion of the risk.

Conclusion

The PLRs provide helpful guidance to determine when certain indemnity reinsurance transactions qualify for section 351 treatment. Importantly, however, the PLRs do not address

all of the respective corollary consequences of section 351 treatment (or lack thereof) and do not provide guidance as to when a permanent transaction is effected in all situations. In any case, the guidance is welcome. ◀

END NOTES

¹ In Rev. Rul. 94-45, 1994-2 C.B. 39, the IRS revoked Rev. Rul. 75-382, 1975-2 C.B. 121, which held that section 351 did not apply to the transfer of cash and other assets by a foreign mutual life insurance company to a newly formed domestic life insurance company for all of its stock followed by an assumption reinsurance agreement. Since then, there have been numerous PLRs where the IRS held that section 351 applied to an indemnity reinsurance transaction as long as novations were anticipated as part of the overall transaction. See, e.g., PLR 201232030 (May 10, 2012); PLR 200737012 (June 14, 2007); PLR 200447004 (July 27, 2004); PLR 200109039 (Dec. 4, 2000); PLR 200017002 (May 19, 1999); PLR 9752059 (Sept. 30, 1997); and PLR 9738031 (June 24, 1997). See also CCA 201501011 (Sept. 4, 2014), where the IRS took a broad view of assumption reinsurance for purposes of determining whether a ceding commission was subject to capitalization under section 197(f)(5).

² Nor did the IRS address the specific consequences of the section 351 transaction with respect to the transfer of assets and liabilities under subchapter L and section 848 (DAC).

³ See also *E.I. DuPont de Nemours & Co., v. U.S.*, 471 F.2d 1211, 1219 (Cl. Ct. because prior to 1992), where the court agreed with the taxpayer that section 351 applied despite the absence of a sale or exchange, because "although the rights granted were not all the rights under the patents, they were perpetual, irrevocable, and quite substantial in value."

in the international tax system due to varying domestic tax regimes, which could lead to BEPS.² The BEPS Action Plan enumerates 15 areas of international tax law, practice and procedure for additional focus. These areas range from the tax challenges of the digital economy to developing more effective treaty amendment and dispute resolution processes. Of particular importance to insurance companies are Action 4, Interest Deductions and Other Financial Payments, and Action 13, Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting.³

Action 4

The OECD's discussion draft on Action 4 reiterates the concern of certain governments that multinational companies can erode their local country tax bases through excessive interest deductions.⁴ The draft states that some entities in a multinational group may be excessively leveraged, and parent companies may borrow to invest in assets that generate income that is deferred or exempt for tax purposes. The Action 4 Discussion Draft expresses the OECD view that current local country limitations on interest expense deductions have not been entirely effective in addressing these issues. The draft further states that a consistent approach for rules on the deduction of interest expense would allow multinationals to plan their capital structures with greater confidence (as the risk of unilateral law changes would be minimized), reduce the risk of double taxation (e.g., situations where the creditor is taxed on interest income but the obligor is denied an interest expense deduction), and make it possible to introduce group-wide systems and processes to generate the information required to implement the limitations.

In order to address these concerns, the draft sets forth several alternative approaches to limiting deductions for interest expense. The principal approaches discussed are (1) a group-wide rule, which would limit a company's net interest deductions to a proportion of the group's actual net third-party interest expense; (2) a fixed ratios rule, which would limit a company's interest deductions to an amount determined by applying a fixed benchmark ratio to an entity's earnings, assets or equity; and (3) certain combinations of these two approaches. The Action 4 Discussion Draft also discusses the use of more targeted approaches. It identifies benefits and drawbacks of the approaches considered, as well as key questions raised by each approach.

David A. Golden is a principal in Ernst & Young LLP's Washington, DC, National Office and the Director of its International Capital Markets tax practice. He may be reached at david.golden@ey.com.

THE OECD'S BASE EROSION AND PROFIT SHIFTING ACTION PLAN: SHOULD INSURANCE COMPANIES CARE?

By David A. Golden

Base Erosion and Profit Shifting Project

In February 2013, the Organisation for Economic Co-operation and Development (OECD) released its highly anticipated report on tax base erosion and profit shifting (BEPS).¹ The report was prompted by the perception of certain member countries that international tax rules have fallen behind rapidly changing international business practices, thereby allowing inappropriate BEPS. The BEPS Report was followed in July 2013 by the OECD's release of its action plan for addressing what it saw as gaps

CONTINUED ON PAGE 50

The discussion draft reiterates the OECD's intention to develop recommendations for a best-practice approach or approaches for countries to use in addressing concerns about BEPS through interest expense. This work is scheduled to be completed by late 2015.

The draft begins with a review of existing approaches used by countries to address BEPS concerns with respect to interest expense. The draft then discusses a series of issues that are relevant to any approach for limiting interest deductions, including what constitutes interest or an economically equivalent payment, what entities should be subject to the limitation, whether the limitation should key off debt amounts or interest expense, and whether it should apply on a gross or net basis.

The Action 4 Discussion Draft also discusses a range of technical, policy and industry-sector issues relevant to the consideration of these approaches. The draft specifically notes that "Banks and insurance companies present particular issues that do not arise in other sectors."⁵ For example, unlike taxpayers in most other industries, banks and insurance companies will usually be recipients of net interest income, such that a rule capping net (as opposed to gross) interest expense would have no direct impact. In addition, the draft acknowledges that interest expense is much more closely tied to the ability of banks and insurance companies to generate income than for taxpayers in other industries. Finally, the draft notes that banks and insurance companies are already subject to non-tax (regulatory) restrictions on their capital structure.

As a result of these industry-specific considerations, the Action 4 Discussion Draft advocates designing a specific rule that focuses on the particular BEPS risks presented by these companies. The draft presents some examples of such a rule. The first would focus on the net interest expense attributable to regulatory capital instruments. A group-wide allocation rule could limit a group's total deductions on its regulatory capital to the amount of interest expense paid on those instruments to third parties. Within the group, the draft suggests that an interest cap could be allocated based on regulatory requirements, but only if that prevents BEPS. Either of these approaches, however, would be difficult for most insurance companies to apply and could lead to distortive and unintended results (such as a misalignment between regulatory and tax positions). Alternatively, the Action 4 Discussion Draft states that "if existing regulatory

requirements act as an effective general interest limitation rule, and prevent excessive leverage in group entities," then a more targeted approach could instead focus on interest expense other than that on regulatory capital.⁶ Appropriately drafted, this approach could avoid many of the issues created by attempting to apply a one-size-fits-all group-wide allocation or debt cap rule.⁷

Action 13

The BEPS Report states that in a truly global economy, local country tax administrators have limited visibility to taxpayers' worldwide operations. In the OECD's view, this, in turn, limits the administration of the arm's-length principle and enhances opportunities for BEPS. In addition, the report states that the variations in countries' transfer pricing documentation requirements lead to significant administrative costs for businesses. Action 13 of the BEPS Action Plan proposed to develop rules on transfer pricing documentation to enhance transparency for tax administrators, taking into consideration the compliance costs for business. The primary goal for these rules was to require taxpayers to provide the relevant governments with information on the global allocation of income, economic activity and taxes paid among countries, using a standardized template.

The report released last September on Action 13 contains standards for transfer pricing documentation and a template for extensive country-by-country (CbC) reporting.⁸ This was followed by further guidance issued in February and June of this year.⁹ They provide that the first CbC reports will be filed for 2016 fiscal years. The CbC reporting template requires multinational enterprises (MNEs) to report the amount of revenue, profits, income tax paid and taxes accrued, employees, stated capital, retained earnings and tangible assets annually for each tax jurisdiction in which they do business. In addition, MNEs are also required to identify each entity within the group doing business in a particular jurisdiction and to provide an indication of the business activities the entity conducts. This information is intended to be shared with tax authorities in all jurisdictions in which the MNE operates.

The guidance on transfer pricing documentation requires MNEs to include a high-level overview of their global business operations and transfer pricing policies in a "master file" that also is to be shared with all relevant-country tax administrators. Specific information would be required

for intangibles and intercompany financial activities. Moreover, the transfer pricing guidance requires that detailed information on all relevant material intercompany transactions be included in a “local file” in each country to be provided to such country’s tax administration.

Although the OECD considered compliance costs to taxpayers, the complexity and level of detail required in the CbC template would still create a substantial compliance burden on insurance companies. Moreover, as with the potential one-size-fits-all approaches in Action 4, the CbC template requires extensive information that is simply not relevant and could be misleading in assessing BEPS implications of a multinational insurance group. For example, employees, stated capital and tangible assets in a particular country could easily give a distorted view of the scope and nature of an insurance group’s activities in that country. Confidentiality considerations are also raised by the wide access various authorities and persons could have to both the CbC template and master file.¹⁰

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

SUBCHAPTER L: CAN YOU BELIEVE IT? WITHHOLDING AND REPORTING MAY NOT BE REQUIRED FOR INCOME ON FAILED LIFE INSURANCE CONTRACTS

By: Peter H. Winslow

A policyholder who owns a contract which is a life insurance contract under applicable law that fails the definition of a life insurance contract in I.R.C. § 7702 is required to treat the income on the contract as ordinary income received or accrued during the taxable year. In general, this income on the failed contract is the amount by which the increase in the net surrender value of the contract plus the cost of insurance exceeds the premiums paid for the year.¹ In Rev. Rul. 91-17,² the IRS ruled that the issuer of a failed contract is subject to the withholding and reporting requirements applicable to nonperiodic distributions from life insurance contracts. The ruling also noted that an insurer’s failure to comply with these withholding and reporting requirements could result in penalties. Is this ruling correct? Believe it or not, the ruling likely is wrong.

The exclusive support for the IRS’s legal conclusion in Rev. Rul. 91-17 is legislative history. The House Committee Report that explains the House bill’s version of what was enacted as I.R.C. § 7702 includes the following statement that assumes that withholding and reporting are required on failed contracts:

Because the income on the contract is treated as received by the policyholder, the income would be a distribution subject to the recordkeeping, reporting, and withholding rules under present law relating to commercial annuities (including life insurance). It is hoped this will provide the policyholder with adequate notice that disqualification has occurred, thus giving some protection against underpayment of estimated taxes.³

Substantially the same statement was included in the post-enactment Joint Committee on Taxation staff’s “Blue Book.”⁴ Because it was the House’s version of I.R.C. § 7702 that was adopted in the Deficit Reduction Act of 1984,⁵ Rev. Rul. 91-17 concludes that the issuer of a failed contract is required

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at pwinslow@scribnerhall.com.

END NOTES

- ¹ Addressing Base Erosion and Profit Shifting (Feb. 12, 2013) (<http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm>) (the “BEPS Report”).
- ² Action Plan on Base Erosion and Profit Shifting (July 19, 2013) (<http://www.oecd.org/ctp/BEPSActionPlan.pdf>) (The BEPS Action Plan).
- ³ The recommendations or “best practices” in the Actions have no legal force unless and until enacted by member countries.
- ⁴ On Dec. 18, 2014, the OECD released a discussion draft under Action 4, titled “BEPS Action 4: Interest Deductions and Other Financial Payments” (<http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf>) (the Action 4 Discussion Draft).
- ⁵ Action 4 Discussion Draft at 62.
- ⁶ *Id.* at 63.
- ⁷ See also Insurance Company Working Group on BEPS Outline of Comments on Action 4 Discussion Draft (Deductibility of Interest), <http://www.oecd.org/tax/aggressive/public-comments-action-4-interest-deductions-other-financial-payments-part1.pdf> at 527.
- ⁸ On Sept. 16, 2014, the OECD released Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting (<http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>).
- ⁹ See <http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf>; <http://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf>.
- ¹⁰ See also Transfer Pricing Documentation and Country-by-Country Reporting Comments by The Insurance Company Working Group on BEPS, <http://www.oecd.org/ctp/transfer-pricing/volume2.pdf> at 344.

CONTINUED ON **PAGE 52**

to withhold and report with respect to the income on the contract.⁶ However, the statement made in the legislative history is inconsistent with the statutory language of the relevant Code provisions. The relevant reporting and withholding provisions are found in I.R.C. § 6047(d) and I.R.C. § 3405. Under I.R.C. § 6047(d), the IRS is granted authority to require information reporting for issuers of contracts “under which designated distributions . . . may be made.” A “designated distribution” subject to withholding is defined in I.R.C. § 3405(e) to include distributions from a “commercial annuity,” which, in turn, is defined to include an annuity, endowment or life insurance contract issued by an insurance company licensed to do business under the laws of any State. So far, so good—the IRS can require withholding and reporting on life insurance contracts.

But wait, I.R.C. § 7702(a) says that a life insurance contract under the applicable law is a life insurance contract “[f]or purposes of this title,” but only if it satisfies the I.R.C. § 7702 cash value accumulation test or guideline premium requirements. Because the withholding and reporting requirements are in the same title as I.R.C. § 7702—Title 26 of the United States Code—a failed contract cannot be a life insurance contract that can produce a designated distribution that is subject to this kind of withholding and reporting obligation.

Thus, there is a conflict between the plain language of the statute and the statement in the legislative history relied upon in the IRS ruling. Without saying so, the IRS must have concluded in Rev. Rul. 91-17 that the conflict should be resolved by following the legislative history. This conclusion is problematic in light of established rules of statutory construction. The Supreme Court has held repeatedly that legislative history can be used as a guide to statutory construction only when the statute is ambiguous.⁷ The only exceptions to this rule are when there is a clearly expressed legislative intent to the contrary that is unequivocal,⁸ or when the plain language produces an absurd or unreasonable result.⁹ Even then, some courts have held that the plain language of the statute can be overridden only when the absurdity is so gross as to shock common sense.¹⁰ If it were up to him, Justice Scalia probably would not resort to legislative history to override the statute even in these circumstances.¹¹

With respect to failed life contracts, the statute is clear and unambiguous that withholding and reporting is not required because these contracts do not qualify as life insurance

contracts for purposes of the Code and so are not commercial annuities as defined in I.R.C. § 3405. Although the legislative history assumes that withholding and reporting should be required, it appears to reflect a misunderstanding by the drafters of the definitional intricacies of applicable withholding and reporting provisions that had been enacted previously in 1982 as part of TEFRA.¹² This likely would not be the type of clear reflection of Congress’ intent that is necessary to override the plain language of the statute. In fact, the language of I.R.C. § 7702(g)(3) itself reflects a contrary Congressional intent. Specifically, I.R.C. § 7702(g)(3) provides that a failed contract is to be treated as an insurance contract, not a life insurance contract, again, for purposes of the entire title.¹³ Thus, the statement in the legislative history contradicts Congress’ express statutory direction to the contrary.

As a practical matter, in most cases the questionable validity of Rev. Rul. 91-17 would not change what an insurer does when it discovers that it has issued failed life insurance contracts. Because of potential lawsuits from policyholders, the insurer usually will want to obtain the retroactive IRS protection available with a failed-contract waiver under I.R.C. § 7702(f)(8) or an IRS closing agreement under Rev. Proc. 2008-40,¹⁴ and request such a waiver or a closing agreement from the IRS National Office to reinstate a failed contract’s qualification as a life insurance contract. The salient point is that the primary reason to pursue such a waiver or closing agreement is to minimize exposure to policyholder claims and class action lawsuits, not to avoid likely unenforceable IRS impositions of penalties for failure to withhold and report the income on the contract. ◀

- ¹ I.R.C. § 7702(g).
- ² 1991-1 C.B. 190, *superseded in part*, Rev. Proc. 2008-40, 2008-2 C.B. 151.
- ³ H.R. Rep. No. 98-432, pt. 2, at 1449 (1984).
- ⁴ Joint Comm. on Taxation, JCS-41-84, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 655 (Dec. 31, 1984).
- ⁵ H.R. Rep. No. 98-861, at 1076 (Conf. Rep. 1984).
- ⁶ The IRS cited Rev. Rul. 91-17 again in Rev. Proc. 2008-40, 2008-2 C.B. 151, Rev. Proc. 2008-42, 2008-2 C.B. 160 and Notice 99-48, 1999-2 C.B. 429.
- ⁷ *Chevron U.S.A. Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984); *Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 460-61 (2002); *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438 (1999).
- ⁸ *Public Citizen v. U.S. Dept. of Justice*, 491 U.S. 440, 452-53 (1989); *Watt v. Alaska*, 451 U.S. 259, 266 (1981).
- ⁹ *United States v. American Trucking Ass'ns, Inc.* 310 U.S. 534, 543 (1940); *Commissioner v. Brown*, 380 U.S. 563, 571 (1965).
- ¹⁰ *Sigmon Coal Co., Inc. v. Apfel*, 226 F.3d 291, 304 (4th Cir. 2000), *aff'd* 534 U.S. 438 (2002); *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575 (1982).
- ¹¹ *Lawson v. FMR, LLC*, 134 S. Ct. 1158 (2014) (Scalia, J., concurring in part); *Graham County Soil and Water Conservation Dist., v. United States*, 559 U.S. 280 (2010) (Scalia, J., concurring in part). This was the thrust of Justice Scalia's dissent in *King v. Burwell*, S. Ct. Dkt. No. 14-114 (Decided June 25, 2015).
- ¹² Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 § 334(a) (1982).
- ¹³ A peer reviewer of an earlier draft of this column pointed out that I had not discussed any actual provision of **Subchapter L** of the Code (which does not include I.R.C. § 3504, 6047 or 7702) even though my regular column is entitled "Subchapter L: Can You Believe It." So, here goes. Because a failed life insurance contract is treated as insurance for all tax purposes, under Subchapter L the premiums are included in gross income and a deduction for tax reserves is allowable. The legislative history suggests that the investment portion of the contract is treated as a reserve under I.R.C. § 807(c)(4). H. R. Rep. No. 98-432 (Pt. 2) 1413 n.10 (1984). Presumably an additional unearned premium reserve also is deductible for the insurance portion of the contract.
- ¹⁴ 2008-2 C.B. 151.

We're here, you know who we are.



But do you know all of the good things we do together?

- improving math skills and financial literacy across the nation
- fostering the best and brightest students and supporting the future of the actuarial profession with scholarships
- educating the public about economics in life situations
- supporting research to benefit the actuarial profession

Take a fresh look at a familiar face.

www.ActuarialFoundation.org



**THE ACTUARIAL
FOUNDATION®**

Preparing for tomorrow's possibilities® through education



SOCIETY OF ACTUARIES

Taxation
Section

475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
p: 847.706.3500 f: 847.706.3599
w: www.soa.org

Taxing
TIMES

NONPROFIT
ORGANIZATION
U.S. POSTAGE
PAID
SAINT JOSEPH, MI
PERMIT NO. 263

