SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

VOLUME 8 | ISSUE 3 | OCTOBER 2012

1 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
By Peter H. Winslow

2 From the Editor
To Our Readers
By Christian DesRochers

4 From the Chair
"So Long, Farewell"
By Kristin Schaefer

11 Life Settlements: Congress Wades Into the Fray
By John T. Adney, Bryan W. Keene and Joshua R. Landsman

17 Recent Developments in Statutory Deferred Tax Accounting Guidance for Life Insurers
By Craig Pichette and Edward L. Robbins

21 Is IRS Consent Needed to Conform Tax Accounting to a Change in Statutory Accounting?
By Peter H. Winslow

24 IRS Third-Party Summonses—Negotiated Cooperation Usually Is the Best Approach
By Samuel A. Mitchell

25 ACLI Update
Foreign Account Tax Compliance Act (FATCA)
By Mandana Parsazad, Pete Bautz, Walter Welsh and James Szostek

28 T³: *TAXING TIMES* Tidbits

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

By Peter H. Winslow

In *American Financial*,[1] the Sixth Circuit held that a life insurance company subsidiary of American Financial Group could compute its tax reserves by using Actuarial Guideline (AG) 33 once its statutory reserves were conformed to AG 33. Providing a breath of fresh air, the court got it exactly right. The court said that if a reserving method prescribed by the National Association of Insurance Commissioners (NAIC) permitted several reserving approaches at the time a contract was issued, then tax reserves can follow statutory reserves when the company changes to another interpretation specified in a new AG. The change is permitted as long as the new AG adopts an approach that was one of the prior permissible options. The court did not say that actuarial guidelines always have retroactive effect, however. For example, the court left open whether a new AG can apply to prior contracts where the NAIC changes its mind and issues an actuarial guideline that adopts a previously impermissible interpretation. Before discussing the *American Financial* case in more detail, it may be useful to provide some background on what the statute requires and the Internal Revenue Service's (IRS's) ruling and litigating positions.

BASIC TAX RESERVE RULES

Under I.R.C. § 807(d), life insurance reserves are required to be computed in accordance with the "tax reserve method" (CRVM for life insurance and CARVM for annuities) prescribed by the NAIC which is in effect on the date of the issuance of the contract. After

CONTINUED ON PAGE 6

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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*.

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FROM THE EDITOR TO OUR READERS

By Christian DesRochers

Welcome to the current issue of *Taxing Times*. I would like to highlight a couple of the articles. The first is an article by Craig Pichette and Ed Robbins on deferred tax accounting. In part, because of the treatment of life insurance reserves and the section 848 DAC, the life insurance industry has significant DTAs, or deferred tax assets. As the authors point out, admitted DTAs account for approximately 12 percent of life industry surplus. Consequently, some knowledge of the development of deferred tax accounting is helpful in understanding the economics of the life insurance industry. In addition, deferred tax accounting is becoming more widely used in modeling blocks of life insurance business for both appraisals and asset adequacy analysis.

The second article is Peter Winslow's discussion of the *American Financial* case. As Peter notes, in *American Financial Group et al. v. United States*, the Sixth Circuit affirmed a district court decision that an insurance company in computing its tax reserves for annuity contracts under IRC Section 807 could apply retroactively Actuarial Guideline 33. The court found that the actuarial guideline applied to the existing annuity contracts as a clarification of the requirements that existed when the contracts were issued. *American Financial* is another element of the mosaic of emerging issues related to the treatment of tax reserves which is creating issues for both the industry and the government. When the current section 807 was written in 1984, traditional reserve methods were dominant. That is, the assumptions underlying life insurance reserves were set at issue and generally did not change over the life of the policy. Changes in mortality tables were infrequent, principally because they required a change in statute or regulation to implement. Only a handful of actuarial guidelines existed, and generally dealt with technical clarifications to the valuation law. In addition, reserves were set on an individual policy basis. These concepts were incorporated into the Internal Revenue Code through the concept of federally prescribed reserves.

Now we are faced with increasingly complex reserve standards, which include stochastic elements which can change annually based on changes in economic conditions. Many valuation tables are promulgated through actuarial guidelines. The effect of codification on the concept of prevailing mortality tables has never been fully clarified, and we are now seeing the emergence of principle-based reserves, bringing with it the potential of reserve standards that will vary by company. All of these elements make it more and more difficult to accommodate the emerging reserve standards with the existing structure of federally prescribed reserves. This creates challenges for both the insurance industry and the Treasury and IRS to find ways to fit emerging reserve standards into section 807.

Thanks to the efforts of a number of authors, we at *Taxing Times* have been active participants in providing timely articles on this emerging issue. As reserves continue to evolve, this will be a topic that will create additional challenges for industry and government, and one which we will continue to provide informed commentary on in future issues.

As always, I'd like to thank all of the authors and support staff who worked on the issue. Without their support, *Taxing Times* would not be possible, and we appreciate their efforts.

Christian DesRochers, FSA, MAAA, is an executive director, Insurance and Actuarial Advisory Services, with Ernst & Young LLP and may be reached at *Chris.DesRochers@ey.com.*

In Memory of CHRISTINE DEL VAGLIO

It is with great sadness that we report the passing of **Christine Del Vaglio** on Aug. 10, 2012, after a valiant battle with pancreatic cancer. Until recently, Christine served as the assistant editor of *TAXING TIMES* beginning with our first issue in May 2005. Her dedication contributed immeasurably to the success of our publication. On behalf of the editorial staff, we would like to extend our deepest sympathy to her husband Dave, and sons Nicholas and Zachary.

Chris and Brian

FROM THE CHAIR
"SO LONG, FAREWELL"

By Kristin Schaefer

I'm sure you recognize this article's title as being the song from the popular musical "The Sound of Music" where the von Trapp children say good-night to the guests at their parents' party. Since I have run out of grandchildren to quote, I'm borrowing phrases from movies for my final article as chair of the Taxation Section. However, even though I have no more grandchildren to brag about, I can brag about the accomplishments of the Taxation Section over the past year.

Here are some highlights:

Meeting Sessions: The Taxation Section sponsored two sessions and a breakfast at the Life and Annuity Symposium in May, one session and a breakfast at the Valuation Actuary Symposium in September, and a record five sessions and a breakfast at the SOA Annual Meeting coming up shortly in October. The sessions provided updates on federal tax issues, activities of the Necessary Premium Task Force, issues with hedging, and other product/reserve issues.

Product Tax Seminar: In our two-year cycle, this was the year for our Product Tax Seminar which was held in September. Although I am writing this before the seminar actually occurs, I'm sure it will be a productive, enlightening meeting for those in attendance.

***Taxing Times*:** The section has continued to produce an informative and timely newsletter. Highlights for this year include the supplement to the May issue on material changes, an analysis of the Foreign Account Tax Compliance Act (FATCA), partial exchange guidance, and many articles covering Private Letter Rulings (PLRs), Revenue Rulings and Technical Advice Memorandums (TAMs). We are blessed with many authors who continue to contribute an amazing assortment of articles.

Podcasts: Thanks to the initiative of Dan Theodore, the Taxation Section has released several podcasts this year. So far they have been recordings of *Taxing Times* articles, and we also hope to provide summaries of webinars in the future.

I can't sign off as chair without thanking several people. First, I'd like to thank the other council members for their assistance during the year. In particular, Dan Theodore, who is also leaving the council this year, has been treasurer for the past three years and secretary for the past year and a half. Thanks also go to our SOA staff partners, Christy Cook and Meg Weber for their help and guidance. And thanks to our staff newsletter editor, Jacque Kirkwood. Last, but not least, a big thanks to all the Friends of the Council who write newsletter articles and speak at meeting sessions. Our section would not be the same without you! I believe I'm leaving the council in good shape and am ready to pass the reins to the capable hands of our incoming chair, Mary Elizabeth Caramagno.

As I write this article, I am desperately trying to cram a few Spanish phrases into my head in preparation for a trip to Peru. So in that spirit, I will end with another movie quote and say, "Hasta la vista, baby!"

Kristin A.L. Schaefer, FSA, MAAA, is an actuary with Transamerica Corporate Actuarial and may be reached at *kristin.schaefer@transamerica.com*.

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the CRVM or CARVM reserve is computed, using the federally prescribed interest rate and mortality table, the reserve is capped by the statutory reserve and floored by the net surrender value on a contract-by-contract basis.

Where there are state-by-state variations on the interpretation of CRVM and CARVM as of the contract issue date, the legislative history provides some general rules as to which interpretation to use for tax reserves. First, the company is required to use the method prescribed by the NAIC as of the date of issuance of the contract, and take into account any factors recommended by the NAIC for the contract. The NAIC-recommended factors to be taken into account are those generally addressed in model regulations or actuarial guidelines prescribed by the NAIC. Second, where no such factors are recommended by the NAIC, or for contracts issued prior to the NAIC's adoption of a regulation or actuarial guideline, companies are to look to the prevailing interpretation of the Standard Valuation Law (SVL), *i.e.*, the interpretation that has been adopted by at least 26 states. The 1984 Blue Book[2] states that, in general, life insurance reserves are computed by starting with the assumptions made for statutory reserves and then making the adjustments required by I.R.C. § 807(d), indicating that, absent an NAIC actuarial guideline or a prevailing interpretation of the states, the tax reserve method should follow the interpretation of the SVL used by the company for its statutory reserves.

26-STATE RULE

Most of the disputes between the IRS and companies over these rules have centered on the meaning of legislative history explaining that a prevailing state interpretation can apply when the NAIC has not issued a specific interpretation of CRVM or CARVM. There is no 26-state rule contained in the I.R.C. § 807(d) definition of "tax reserve method." Instead, the statute unambiguously defers to the NAIC's interpretation of CRVM or CARVM. The legislative history, therefore, provides a gloss on the statute and is consistent with the statute only if it is construed to mean that, when a majority of NAIC members have formed a uniform position as to the correct interpretation of an NAIC-prescribed method (*i.e.,* 26 states have adopted the same interpretation of the SVL thus making it prevailing), then the NAIC will be presumed to have adopted that interpretation. In such a case, because the NAIC will be deemed to have prescribed the view of a majority of its members, it governs for the tax reserve method. This construction of the legislative history has important implications. Specifically, it means that when considering an interpretation of CRVM or CARVM where there is no applicable NAIC interpretation on point, then a uniform view of 26 states can be applied, but only in the same way as if the NAIC had issued an actuarial guideline setting forth the majority states' view. There is no separate 26-state rule for the tax reserve method that applies independently from the NAIC-prescribed method the statute requires.

Let's apply this basic principle to a situation where the NAIC, directly by an actuarial guideline or indirectly by a majority of states, allows several optional approaches to implement CRVM or CARVM. Can the company choose any optional interpretation or must it choose the option that yields the smallest reserve permitted by the NAIC guidance or by 26 states? It so happens that the legislative history addresses this question. The Blue Book at page 599 states that when "methods and assumptions" are not prescribed by I.R.C. § 807(d), the ones actually used for statutory reserves should apply for tax reserves. The specific example used in the legislative history is the choice between continuous or curtate functions. The legislative history states that either assumption is permissible for tax reserves as long as it is consistent with the assumption used for statutory reserves.

Thus, based on the legislative history, the following basic rules can be said to apply when there are several permissible interpretations of CRVM or CARVM.

Rule No. 1 – When the NAIC through a model regulation or AG provides for more than one approach to computing CRVM or CARVM reserves at the time the contract was issued, then the approach used for statutory reserves should be used for tax reserves. This is so regardless of whether another permissible approach would have yielded smaller tax reserves.

Rule No. 2 – When the NAIC issues a new model regulation or an AG which mandates a single approach that was one of several approaches previously permissible, then tax reserves should conform to statutory reserves computed using the new NAIC requirement. This is so even if tax reserves previously were computed using another interpretation that was permissible at the time the contract was issued.

Rule No. 3 – Where the NAIC is silent on an interpretation, then the statutory reserve approach should be used for tax reserves unless it is inconsistent with a single uniform approach within the NAIC-prescribed method required to be used by 26 states at the time the contract was issued. As in the case of an NAIC guideline that allows several options, there is no requirement for tax reserve assumptions or interpretations to depart from permissible statutory reserves other than as required by I.R.C. § 807(d) even if this results in greater reserves than 26 states otherwise specifically would have allowed when the contract was issued.

CHANGING IRS POSITIONS

In its initial guidance, the IRS applied these rules correctly. In Rev. Rul. 94-74 (Situation 3),[3] the company changed its statutory reserves assumption from using curtate to continuous functions. The ruling concludes that, because the NAIC did not require either assumption to be used for purposes of determining minimum acceptable reserves under state law, the company was required to conform its tax reserves to the new statutory reserves using continuous functions. The ruling reached this result even though the new statutory reserve assumption yielded greater tax reserves. The 10-year spread rule of I.R.C. § 807(f) was held to govern because there was a change in the basis of computing tax reserves. The principle set forth in Rev. Rul. 94-74 was followed in TAM 200108002 (Oct. 24, 2000). In that TAM, the taxpayer changed its tax reserves to conform with its statutory reserves for structured settlement annuity contracts using a graded interest valuation method. The IRS upheld the conforming change in the tax reserve computation because it was one of several permissible methods that could have been adopted by the company at the time the contracts were issued.

The TAM also adopted a minimum reserve requirement on the prevailing-state-interpretation standard when an item is not addressed directly by the NAIC.

In two subsequent technical advice memoranda, the IRS departed from its prior ruling position and created the dispute that led to the *American Financial* litigation. In TAM 200328006 (March 20, 2003), the IRS adopted the position, in a case involving AG 33, that tax reserves for contracts issued before the effective date of a new actuarial guideline cannot take the guideline into account. The TAM ignored the fact that at least some of the taxpayer's statutory reserve changes may have been permissible interpretations of CARVM when the annuity contracts were issued prior to the adoption of AG 33.

In TAM 200448046 (Aug. 30, 2004), the IRS took a similar position, but provided a more detailed explanation this time. The question in TAM 200448046 was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with guaranteed minimum death benefits that were issued before the adoption of AG 34. For statutory purposes, the taxpayer had used the method required by the Connecticut Insurance Department which, for purposes of computing the CARVM reserves, required an assumption of a one-third drop in asset value. According to the TAM, the Connecticut asset-drop assumption was not required by any other state as of the issue date of the contracts and resulted in greater reserves than were required under the AG 34 method that subsequently was adopted. Instead of attempting to determine whether there was a single uniform prevailing state interpretation of how CARVM applied before the adoption of AG 34, the IRS concluded that the taxpayer could not use the Connecticut method because at least 26 states permitted smaller reserves for variable annuity contracts with guaranteed minimum death benefits. In doing so, the TAM seems to have reasoned that a prevailing view of the states can be gleaned from passive acceptance by state regulators of CARVM interpretations made by companies filing Annual

CONTINUED ON PAGE 8

Statements. The TAM also adopted a minimum reserve requirement on the prevailing-state-interpretation standard when an item is not addressed directly by the NAIC. Even though there was no single prevailing state interpretation of CARVM and even though a majority of states permitted several interpretations of CARVM, the TAM concluded that tax reserves must be computed using the method that yielded the smallest reserve permitted by at least 26 states. This was a significant departure from the IRS's previous rulings in Rev. Rul. 94-74 and TAM 200108002.[4]

AMERICAN *FINANCIAL CASE*

Not surprisingly, the IRS's position as expressed in TAM 200328006 was challenged in the *American Financial* case. American Financial's subsidiary, Great American Life Insurance Company (GALIC), issued deferred annuity contracts. After AG 33 was adopted by the NAIC in 1995, GALIC recomputed its statutory reserves for all its contracts, including those contracts issued before 1995, to comply with the new guideline. Two of GALIC's reserve changes related to interest rate assumptions and a third change was to take into account the partial surrender and partial annuitization options that had not previously been considered. GALIC conformed its tax reserves to its AG 33 statutory reserves and deducted the increase in tax reserves applying the 10-year spread rule of I.R.C. § 807(f).

The Government argued that, when new AGs are issued by the NAIC, they change CARVM and, therefore, AGs cannot apply to contracts issued before they are adopted by the NAIC. Because there was no previous AG on point, following the reasoning of TAM 200448046, the Government argued that the 26-state rule should apply. The Government acknowledged in its briefs, however, that there was no single prevailing view of the states on the details of computing CARVM reserves for GALIC's contracts at the time the contracts were issued. Nevertheless, it argued that GALIC was required to continue using its prior reserving approach because it had been accepted by state regulators and yielded a smaller reserve that was permissible by the states when the contracts were issued. The District Court for the Southern District of Ohio rejected these arguments.[5] It noted that AG 33 did not amend the definition of CARVM and is only an interpretation of the SVL. The district court concluded that the statute defers to the NAIC for the tax reserve method. As a result, the court found that when the NAIC specifies that an AG is an interpretation of the SVL in effect at the time the contract was issued, I.R.C. § 807(d) requires that interpretation to apply for tax purposes to that contract.

The district court's opinion was a big win for the taxpayer and was read by some to mean that AGs always should be accorded "retroactive" effect because they are merely interpretations of the SVL. But, at least one commentator questioned whether this broad interpretation is correct.[6]

The Government appealed the district court's decision, but the Sixth Circuit affirmed in an opinion issued on May 4, 2012.[7] Simply stated, the Sixth Circuit's opinion effectively placed us back to where we were under Rev. Rul. 94-74 and TAM 200108002 before the IRS went off course by applying its own version of the 26-state rule in TAMs 200328006 and 200448046. The court held that GALIC's use of AG 33 was proper because it was a permissible interpretation of CARVM at the time the contracts were issued. Relying on Rev. Rul. 94-74, the court adopted the following rule when the company makes a change to its statutory reserves:

> The parallel to this case is unmistakable: (1) the reserving method prescribed by the Commissioners in effect at the time the contracts were issued permitted either of two approaches; (2) the taxpayer permissibly applied on approach for several years; (3) the taxpayer then changed to the other permissible approach in calculating its state-law reserves, leading to higher reserve figures. As Revenue Ruling 94-74 demonstrates, § 807 permits the taxpayer to make the identical change for federal tax purposes.[8]

The Government relied on legislative history of the 1984 Act explaining that tax reserves under I.R.C. § 807(d) generally will approximate the smallest reserve that would be required under the prevailing law of the states. From this observation in the legislative history, the Government contended that any time a state insurance department accepts a company's calculation for one year, the company can never increase its tax reserve based on a change in statutory reserves regardless of whether a new AG is prescribed and regardless of whether the new approach was permissible when the contract was issued. The Sixth Circuit squarely rejected this argument.

Importantly, the Sixth Circuit did not say that AGs always will apply to previously issued contracts. The court left open the possibility that the NAIC itself can change its mind and, by an AG, change its own prior interpretation of CRVM or CARVM. In such a case, the court left open whether the new AG would apply to contracts issued before the AG was adopted by the NAIC.

IMPLICATIONS OF *AMERICAN FINANCIAL*

The *American Financial* case has many ramifications on pending (and potential) disputes between the IRS and taxpayers. In the short-term, it seems that the IRS's position that AG 34 cannot be applied to prior contracts has been rejected. This may not make much of a difference, however. In the case of *CIGNA Corp. v. Commissioner,*[9] the IRS in oral argument and in a reply brief filed on Dec. 21, 2011, represented to the Tax Court that the IRS "had no intent to raise the AG 34 issue with legal position other taxpayers."[10]

The *American Financial* case also confirms indirectly that where an actuarial guideline provides for several reserve options, the option used for statutory reserves should be followed for tax reserves (for example, AG 35 applicable to equity indexed annuity contracts provides for several optional approaches). There is no requirement to use the AG option that yields the smallest reserve.[11]

Further, the *American Financial* case can be read to confirm that where statutory reserves are changed from an interpretation that was permissible at the time the contract was issued to another permissible interpretation, tax reserves can (or even should) likewise be changed to conform to the new statutory reserve approach. As in Rev. Rul. 94-74, this is so whether or not the change to statutory reserves was prompted by the NAIC's adoption of a new AG.

More broadly, both opinions of the Sixth Circuit and the district court underscore that I.R.C. § 807(d) defers to the NAIC to determine the applicable tax reserve method. There is no room in the statute for the IRS to second-guess the NAIC and select its own tax reserve method. The Sixth Circuit stated: "If the National Association of Insurance Commissioners replaces the existing model for reserves calculations (the Standard Valuation Law) or materially amends it, a company could apply that law for tax purposes only to contracts issued after its effective date."[12] This observation of the court has important implications when, and if, the NAIC changes the SVL to adopt principle-based reserves. It could be read to mean that, although a new NAIC-prescribed reserving method will not apply to previously issued contracts, it will govern for new contracts even if it is a "material" change. If this reading is correct, the IRS's ability to limit the application of a new reserving method prescribed by the NAIC to newly issued contracts may be circumscribed by the *American Financial* reasoning even if that reserve method is not comparable to current CRVM or CARVM.[13]

Finally, the Sixth Circuit's opinion in *American Financial* does not resolve the issue as to whether a new AG can apply to contracts issued before it has been adopted by the NAIC, where the new AG supercedes a prior inconsistent AG. One could argue that the new AG should apply to previously issued contracts because it is an interpretation of the SVL which has not changed; the more recent "correct" NAIC interpretation should govern for tax purposes too. On the other hand, it could be argued that if, at the time

There is no room in the statute for the IRS to second-guess the NAIC and select its own tax reserve method.

CONTINUED ON **PAGE 10**

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the contract was issued, there was a clear NAIC-prescribed AG, the statute requires its use as the tax reserve method even if the NAIC later changes its mind and supercedes its prior interpretation.

Under the latter view, a further complication can arise when the NAIC adopts a new AG that requires the use of some assumptions or interpretations that were permissible prior to the adoption of the new AG and some that were not. AG 43 is a case in point. Prior to the adoption of AG 43 several of the new requirements in computing the Standard Scenario Amount were permissible for variable annuity contracts with guaranteed minimum benefits, but some were not (*e.g.,* lapse assumptions were not permitted under AG 33 or AG 34). Thus, assuming that AG 43 cannot be applied wholesale to previously issued contracts, the proper approach for pre-AG 43 contracts would be to conform tax reserves to the new AG 43 statutory reserves, but only to the extent the statutory reserve assumptions would have been permissible under prior NAIC guidance at the time the contracts were issued. A recent article in *Taxing Times* suggests in detail how this approach can be implemented for AG 43.[14]

END NOTES

1. *American Financial Group v.* U.S., No. 10-3991, 2012 WL 1560393 (6th Cir. 2012).
2. Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984 (Comm. Print 1984).*
3. 1994-2 C.B. 157.
4. *See* Peter H. Winslow & Susan J. Hotine, *IRS Requires Use of Prevailing State Minimum Reserve Standard Where There is No Specific NAIC Guidance at Issue Date,* T3: *Taxing Times* Tidbits, 15, *Taxing Times*, Vol. 1, Issue 2 (Sept. 2005).
5. *American Financial Group v.* U.S., 726 F.Supp.2d 802 (S.D. Ohio Mar. 15, 2010).
6. Richard N. Bush, *IRS Rules on American Financial,* 10 *Taxing Times*, Vol. 6, Issue 2 (Sept. 2010).
7. *American Financial, supra* note 1.
8. *Id. See also* Peter H. Winslow, *Common Myths in Interpreting the Company Tax Provisions of the 1984 Act,* 50 *Taxing Times*, Vol. 5, Issue 3 (Sept. 2009), explaining the same interpretation of the statute.
9. No. 013645-09 (Tax Ct. filed June 4, 2009).
10. *Id. See also* Peter H. Winslow, *What is the Tax Reserve Method "as of" the Date of Issuance of the Contract?*, 1 *Taxing Times*, Vol. 7, Issue 3 (Sept. 2011), for a discussion of the parties' arguments in the *CIGNA* case.
11. This is in contrast to I.R.C. § 807(d)(5)(E) which provides that when there are several options or tables for mortality or morbidity, the prevailing commissioners' standard table is the option or table which generally yields the lowest reserve. There is no comparable smallest-reserve requirement for the "tax reserve method."
12. *American Financial Group,* 2012 WL 1560393, *2.
13. *See* Edward L. Robbins & Peter H. Winslow, *Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM,* 1 *Taxing Times*, Vol. 3, Issue 1 (Feb. 2007); Christian DesRochers & Peter H. *Winslow, Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II),* 1 *Taxing Times*, Vol. 3, Issue 2 (May 2007); Brian G. King, Christian DesRochers, Edward L. Robbins, & Peter H. Winslow, *Tax Attorney and Tax Actuary Dialogue on IRS Notice 2008-18-AG VACARVM and Life PBR (Part III), Taxing Times* Supplement (March 2008); Peter H. Winslow, *The Tax Reserve Method Should be PBR Once It Is Adopted by the NAIC,* 24 *Taxing Times*, Vol. 4, Issue 3 (Sept. 2008).
14. Peter H. Winslow & Michael LeBouf, *How are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?* 1 *Taxing Times*, Vol. 7, Issue 2 (May 2011).

LIFE SETTLEMENTS: CONGRESS WADES INTO THE FRAY

By John T. Adney, Bryan W. Keene and Joshua R. Landsman

Last spring the United States Senate, by voice vote, added a revenue-raising amendment to the House-passed Moving Ahead for Progress in the 21st Century Act (more affectionately known as the "highway bill") that would change a number of tax requirements regarding so-called life settlements. As amended by the Senate, the bill would have (1) imposed tax reporting requirements with respect to life settlements, (2) modified the "transfer for value" rule of section 101(a)(2) in cases of a commercial transfer of a life insurance contract, and (3) reversed a position the Internal Revenue Service ("IRS") took in Rev. Rul. 2009-13[1] regarding how tax basis is determined for a contract involved in a life settlement.[2]

In the congressional "conference committee" process, during which members of the Senate and the House of Representatives negotiated the final contents of the bill, the life settlement provisions were dropped.[3] As a result, the final bill, which President Obama signed into law on July 6, 2012, did not include the Senate amendment (hereinafter, the "Amendment"). Nonetheless, the Amendment was significant, apart from its substance, in three respects: it was sponsored by Sen. Max Baucus (D-MT), who is the chairman of the tax-writing Senate Finance Committee, it was generally supported by both life insurance and life settlement industry trade groups[4] and approved in the Senate without objection, and it would have raised a modest amount of revenue.[5] In view of these characteristics, it seems likely that the proposals in the Amendment could eventually become law as part of some future legislative vehicle.

This article will examine each of the Amendment's three proposals, beginning with a discussion of the background and current status of life settlements in the United States. The article will then explain, in order, the Amendment's proposals relating to reporting for life settlements, the modification of the transfer for value rule for such transactions, and the reversal of the IRS position in Rev. Rul. 2009-13. The article will conclude with an assessment of the anticipated effect of the proposed legislative changes on life insurers.

BACKGROUND AND CURRENT STATUS OF LIFE SETTLEMENTS

In general, a life settlement can be described as a transaction in which a life insurance contract owner sells the contract to a third party, presumably for an amount that exceeds the contract's cash surrender value but is less than the expected death benefit.[6] The ability of a life insurance contract's owner to transfer the contract in a sale transaction was most notably featured in the Supreme Court's 1911 holding in *Grigsby v. Russell*.[7] There, the Court, in an opinion by Justice Oliver Wendell Holmes, Jr., held that life insurance contracts are assets and, as such, are freely assignable.

The AIDS crisis during the 1980s has been cited as the triggering event that sparked the secondary market for life insurance contracts.[8] During the early period of the crisis, AIDs patients needed to pay for the high cost of medical care, and many had a life insurance contract as an asset.[9] Investors were willing to pay AIDs patients an advance on their life insurance death benefits (and more than the contracts' cash surrender values) in exchange for the rights to the contracts' full death benefits.[10] In 1993, the National Association of Insurance Commissioners ("NAIC") adopted the first Viatical Settlement Model Act, to encourage the promulgation of rules that would regulate the sale or transfer of a benefit under a life insurance contract. Several states adopted this Model Act, which some attribute to the development of a secondary market for life insurance contracts, known as the viatical settlement market.[11]

Advancements in the treatment of the AIDS virus and the prolonged life expectancy of individuals with AIDS shifted the focus of this secondary market to seniors who wanted to sell their life insurance contracts.[12] The settlement of life insurance contracts to seniors has become known by the more general term "life settlements," while the term viatical settlements refers to the settlement of contracts insuring the lives of individuals with a life expectancy of less than two years.[13]

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In 2007, the NAIC revised the Viatical Settlement Model Act to address several issues in the life settlement marketplace, including the emergence of a practice known as Stranger-Originated Life Insurance (STOLI).[14] Such STOLI transactions have been defined as life insurance contracts manufactured for the purpose of settling in the secondary market. The life insurance industry has mounted a campaign of opposition to this practice, which it considers a significant abuse.[15]

Recently, there has been a decline in the life settlements market.[16] In 2008, the total face value of life settlement contracts was $12.95 billion. In 2009, however, this number dropped to $7.01 billion.[17] According to a 2011 report, the U.S. life settlement industry saw sales drop about 50 percent in 2012 to roughly $3.8 billion in face value.[18] Some commentators cite, *inter alia*, the recent economic and credit crisis as the reason for this downturn, including the collapse of the subprime mortgage market in 2009 that caused many investors to scale back capital investments.[19] Others have suggested that the downturn in the life settlements market was caused by the nature of the investment required. For example, some have referred to life settlements as a "wasting asset" that requires significant up-front capital to pay premiums of 5-10 percent of face per year and with a possible three-year or more period before any death benefit (*i.e.*, the "return" on the investment) is paid.[20]

Life settlement industry leaders believe that there are still additional challenges facing their industry. Fears that the U.S. economy could fall into a "double-dip" recession have caused investors to hold back capital. Further, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, federal regulators are debating whether to define life settlement transactions as securities, a proposal that would place them under the jurisdiction of the U.S. Securities and Exchange Commission.[21] Despite these challenges, some believe that the life settlements market may soon be reinvigorated: one recent article estimated that the potential market could reach over $177 billion over the next 10 years due to billions of dollars that retiring (and aging) baby boomers have invested in life insurance contracts.[22]

Insurance companies themselves also have taken steps with their product designs and features to address consumer demand for life settlement options. Due in part to the rising popularity of viatical settlements during the 1980s and 1990s, insurance companies began adding accelerated death benefit riders to life insurance contracts. In 1996, the Health Insurance Portability and Accountability Act added sections 101(g) and 7702B to the Code.[23] In very general terms, those Code sections facilitate favorable tax treatment in cases where the insured under a life insurance contract suffers from a terminal or chronic illness by excluding from gross income (1) benefits paid under the contract before the insured's death, and (2) amounts received in a sale of the contract to a viatical settlement provider. This favorable treatment does not extend to life settlements more generally, however, such as cases where a healthy senior wants to sell his contract to a third party for more than its cash surrender value. In such cases, as discussed below, the sale is generally taxable to the owner under section 1001 and the purchaser generally must include the death benefit in gross income (to the extent it exceeds the consideration paid) pursuant to the "transfer for value rule" of section 101(a)(2).

With regard to this broader life settlements market—and STOLI in particular—the life insurance industry has advocated legislative and regulatory changes to curb perceived abuses. These efforts led the Treasury Department to include in the Obama Administration's fiscal year 2012 budget two proposals regarding life settlements. In its official explanation of the budget proposals (called the "Greenbook"), the Treasury Department observed that "[c]ompliance is sometimes hampered by a lack of information reporting" with respect to life settlements, and that "the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies."[24] In light of these concerns, the Greenbook explained the Treasury Department proposals as (1) requiring information reporting by third-party purchasers of life insurance contracts that provide death benefits of $500,000 or more, and (2) modifying the transfer for value rule to "ensure that exceptions to that rule would not apply to buyers of policies."[25] These proposals would eventually serve as the blueprint for two of those reflected in the Amendment. The Chairman then added the provision reversing the IRS position in Rev. Rul. 2009-13, which went a long way towards ensuring the life settlement industry's support for the Amendment. The Amendment's three proposals are discussed next.

THE AMENDMENT'S PROPOSED REPORTING REQUIREMENTS FOR LIFE SETTLEMENTS

Currently, information reporting is not required in circum-

stances involving the sale of a life insurance contract. The Amendment would have helped close this information gap by requiring reporting for individuals, both buyers and sellers, who engage in a "reportable policy sale." The Amendment defined such a sale as:

> The acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term 'indirectly' applies to the acquisition of an interest in a partnership, trust or other entity that holds an interest in a life insurance contract.

Accordingly, sales of life insurance contracts in the secondary market (*i.e.*, life settlements) would have constituted reportable policy sales under the Amendment.

Under the Code's information reporting rules as modified by the Amendment, if a sale of a life insurance contract were a reportable policy sale, the buyer would have been required to provide certain information in a return filed with the IRS. This information would have included (1) the name, address, and taxpayer identification number (TIN) of the buyer, (2) the name, address, and TIN of each recipient of a payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer of the contract sold and the policy number of such contract, and (5) the amount of each payment.

In addition to filing a return, the buyer would have been required to furnish a written statement to the seller and the life insurance company setting forth (1) the name, address and phone number of the buyer, and (2) the information required to be shown on the return with respect to the seller and the insurer. However, the buyer would not have been required to disclose to the insurer that issued the contract the amount for which the policy was sold—a feature that was necessary to the life settlement industry's support for the Amendment.

The Amendment also included a provision requiring the life insurer that issued the seller's contract to make a return to the IRS reporting the seller's adjusted basis in the life insurance contract. (How one determines such basis is discussed below, in the context of Rev. Rul. 2009-13.) The return would have included (1) the name, address, and TIN of the seller who transfers any interest in the contract, (2) the investment in the contract (as defined in section 72(e)(6)) with respect to the seller, and (3) the policy number of the contract. In addition, the insurer would have needed to provide a written statement to the seller detailing the information that was required to be provided in the return.

Finally, payors of "reportable death benefits" would have been required to file a return setting forth (1) the name, address, and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of the payment, (3) the date of each payment, and (4) the amount of each payment. Under the Amendment, "reportable death benefits" were defined as "amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale." Thus, proceeds payable to the buyer under a life settlement would have been reportable death benefits.

Overall, the proposal provided a reporting regime that would have allowed buyers and sellers to be made aware of the tax consequences of the sale of the life insurance contract, and would have enabled both the IRS and the issuing life insurer to track sales of contracts in the secondary market. The Amendment would have applied to reportable policy sales occurring after Dec. 31, 2012, and to reportable death benefits paid after that date.

THE AMENDMENT'S PROPOSED CHANGES TO THE TRANSFER FOR VALUE RULE

There has been no change in the substance of section 101(a)(2)'s transfer for value rule since 1942. Under that provision in its current (and original) form, when the owner of a life insurance contract transfers some or all of the benefit under the contract (other than in a collateral assignment) to another party *for consideration*, the normal tax-free status of the death proceeds under section 101(a)(1) is precluded and the purchaser of the policy is required to pay income tax on the full amount of the death benefit in excess of the consideration and any premiums that the purchaser paid for the contract. Since 1942, section

> The Amendment would have helped close this information gap by requiring reporting for individuals, both buyers and sellers, who engage in a "reportable policy sale."

CONTINUED ON **PAGE 14**

101(a)(2) has provided exceptions to this general rule for certain transfers, *i.e.*, a transfer to the person insured under the contract, to a partner of the insured, or to a partnership or corporation in which the insured is a partner or officer or shareholder, as well as a transfer in which the transferee's cost basis in the contract is calculated by reference to the transferor's basis.

The Amendment proposed to make an exception to these exceptions to the transfer for value rule in the case of "commercial transfers." The Amendment provided as follows:

> (3) EXCEPTION TO VALUABLE CONSIDERATION RULES FOR COMMERCIAL TRANSFERS.— (A) IN GENERAL.—The second sentence of paragraph (2) shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale.

As described above, a "reportable policy sale" referred to the acquisition of an interest in a life insurance contract, directly or indirectly (including *via* an entity that holds the contract), if the acquirer had no substantial family, business or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. The proposed amendment would have applied to transfers after Dec. 31, 2012.

THE AMENDMENT'S PROPOSED REVERSAL OF THE IRS HOLDING IN REV. RUL. 2009-13

The third and final change that the Amendment would have accomplished was to overrule the IRS position in Rev. Rul. 2009-13 regarding how an individual's tax basis in a life insurance contract is determined upon a sale of the contract. As a general matter, section 72 governs the tax treatment of amounts received under a life insurance contract prior to the insured's death, with such amounts being taxable by reference to the owner's "investment in the contract," as defined in section 72. In contrast, section 1001—regarding the "sale or other disposition of property"—generally governs the tax treatment of amounts received upon the sale of a life insurance contract by its owner to a third party, with such amounts being taxable by reference to the owner's "adjusted basis" in the contract, as defined in section 1011. Because different Code sections apply in these situations, it is possible for different tax results to occur with respect to life settlements (*i.e.*, the sale of a contract) *versus* other policy transactions (*i.e.*, surrenders, withdrawals, and loans).

The IRS made this observation in a pair of 2009 revenue rulings involving life settlements and used it to rationalize disparate treatment of a taxpayer who surrenders *versus* sells his or her contract.[26] In particular, the IRS in Rev. Rul. 2009-13, *Situation 2*, concluded (to the surprise of many) that in the case of an individual who purchased a life insurance contract to provide insurance protection to his or her family, the "adjusted basis" of the contract under section 1011 used to determine gain on the contract's subsequent sale must be reduced by cost of insurance ("COI") charges previously paid under the contract.

In *Situation 2*, taxpayer "A" sold a life insurance contract for $80,000 some eight years after purchasing it to a person unrelated to the taxpayer who would suffer no economic loss on the taxpayer's death, *i.e.*, a party who lacked insurable interest. The contract's cash surrender value at the time of the sale was $78,000, which reflected the addition of interest credits and the subtraction of $10,000 of COI charges that the issuer had previously collected under the contract. Through the date of the sale, A had paid premiums totaling $64,000. The IRS concluded that the seller's adjusted basis in the contract should be reduced by "that portion of the premium paid for the contract that was expended for the provision of insurance before the sale," *i.e.*, the COI charges. In reaching this conclusion, the IRS relied extensively on *dicta* from several cases decided in the 1930s,[27] in addition to citing to (*inter alia*) sections 1011, 1012, and 1016 and the regulations thereunder.

Both the life insurance industry and the life settlement industry disagreed strongly with the IRS' conclusion in *Situation 2*, arguing that it was inconsistent with the general federal income tax treatment of similar transactions in property by individuals. For example, in the case of personal property unrelated to business or investment, the federal tax law generally makes no provision for adjusting the basis of the property to account for personal use or consumption.[28] In determining gain on the sale of such property, the property's basis equals its cost, unadjusted for personal use or consumption.[29] Conversely, where there is a loss on the sale, no deduction is allowed, save in the case of casualty.[30] For these reasons, the ruling's critics argued that a life insurance contract held by or for the benefit of an individual, apart from a business or investment activity, constitutes personal use property, and absent a specific statutory rule dictating a different result, the contract's adjusted basis should be determined in the same manner as adjusted basis in connection with other sales of personal property.[31]

The Amendment appeared to adopt the critics' view of these rules by reversing the IRS conclusion in *Situation 2* of Rev. Rul. 2009-13. The Amendment would have accomplished this by amending section 1016 to specify that there would be no adjustment to the basis of a life insurance contract "for mortality, expense or other reasonable charges incurred under an annuity or life insurance contract." The Amendment's inclusion of this change was a major reason why the life insurance industry and the life settlement industry supported the Amendment. In addition, the Amendment characterized the change as a "clarification" of current law, thereby confirming both industries' longstanding understanding of the manner in which section 1001 and related rules apply to life insurance contracts. Further evidencing the nature of the provision as a clarification rather than a substantive change in law, the Amendment would have applied the provision retroactively to transactions entered into after Aug. 25, 2009, which is the effective date of Rev. Rul. 2009-13.

CONCLUSION

As noted above, President Obama signed the highway bill into law on July 6, 2012, and the Amendment was not included as part of the final bill. Nonetheless, because the Amendment enjoyed broad support, raised some greatly needed revenue, and was not viewed as controversial—recall the voice vote in the Senate—it will likely show up in other legislation in the future. If the Amendment represents the full extent of life insurance-related legislation that passes Congress in 2012 or 2013, it will serve a useful purpose. ◂

END NOTES

1 2009-21 I.R.B. 1029.
2 *See* sections 100112-14 of the Moving Ahead for Progress in the 21st Century Act, H.R. 4348, 112th Cong. (2012), as amended by S.Amdt. 1825 (Mar. 8, 2012). Unless otherwise indicated, our references to "section" or "sections" mean sections of the Internal Revenue Code of 1986, as amended (the "Code").
3 *See* H.R. Rep. No. 112-557 (Conf. Rep.) (2012).
4 The groups that supported the Amendment included the American Council of Life Insurers (ACLI) and the Life Insurance Settlement Association (LISA).
5 The amendment is currently projected to raise $244 million over 10 years. The substance of the amendment was contained in a bill, S.1813, 112th Cong. (2012), previously introduced by Sen. Robert Casey (D-PA).
6 *See* Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission 3 (2010) (the "SEC Report").
7 222 U.S. 149 (1911). In *Grigsby*, a life insurance policyholder sold his policy to a third party and the seller's estate challenged the purchaser's right to the death benefits after the seller died, on the grounds that the purchaser lacked an insurable interest in the seller's life. In upholding the purchaser's right to the death benefits, Justice Holmes said that "[s]o far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. To deny the right to sell except to persons having [an insurable interest] is to diminish appreciably the value of the contract in the owner's hands." *Id.* at 156. For more information on the history of life settlements, see Life Insurance Settlement Association, Life Settlement History *available at* http://www.lisa.org/content/51/Life-Settlement-History.aspx (last visited June 14, 2012).
8 *See* SEC Report, supra note 6, at 3; see also U.S. Gov't Accountability Office, GAO-10-775, Report to the Special Committee on Aging, U.S. Senate, Life Insurance Settlements: Regulatory Inconsistencies May Pose a Number of Challenges 8 (2010) (the "GAO Report").
9 *See* SEC Report, *supra* note 6, at 3.
10 *Id.*
11 *Id.*
12 *Id.*
13 Charles Delafuente, *When Life Insurance is More Valuable as Cash, N.Y. Times (Mar. 3, 2010), http://www.nytimes.com/2010/03/04/business/retirementspecial/04LIFE.html.*
14 *See* NAIC News Release, NAIC Adopts Viatical Settlements Model Act Revisions (June 4, 2007) available at http://www.naic.org/Releases/2007_docs/viatical_settlements_model.htm.
15 *See, e.g.,* Letter of American Council of Life Insurers addressed to Mary L. Shapiro, Chairwoman of the U.S. Securities and Exchange Commission (Oct. 6, 2011) available at *http://www.acli.com/Issues/Pages/CT11-133.aspx* (urging the SEC to adopt recommendations to curb STOLI).
16 *See* SEC Report, *supra* note 6, at 3.
17 GAO Report, *supra* note 8, at 8.
18 Fran Matso Lysiak, *Conning: Life Settlement Sales Drop About 50% in 2010; Investors Focused on 'Distressed' Portfolios,* Best's News Service (Oct. 6, 2011).

CONTINUED ON **PAGE 16**

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END NOTES CONT.

19 Goldman Sachs, a major player in the life settlements market, exited the market in 2010, and Deutsche Bank, another industry leader, had earlier downsized its operations in the market. *See* SEC Report, *supra* note 6, at 4; *see also* Jeff Jeffrey, *Life Settlement Industry Sees Signs of Growth, but Questions Remain,* Best's News Service (Aug. 8, 2011).

20 SEC Report, *supra* note 6, at 4.

21 *See* Jeffrey, *supra* note 19; SEC Report, *supra* note 6, at 39.

22 Jeff Jeffrey, *Betty White Ad Signals Attempt by Life Settlement Industry to Buck Their Niche Status,* Best's News Service (Feb. 21, 2012).

23 Pub. L. No. 104-191 (1996).

24 U.S. Dep't of Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals 51 (2011).

25 *Id.*

26 Rev. Rul. 2009-13, 2009-21 I.R.B. 1029; Rev. Rul. 2009-14, 2009-21 I.R.B. 1031.

27 London Shoe Co. v. Comm'r, 80 F.2d 230 (2d Cir. 1935) (involving the deductibility of a loss on surrender); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3d Cir. 1934) (involving the deductibility of a loss on sale); Keystone Consolidated Pub. Co. v. Comm'r, 26 B.T.A. 1210 (1932) (involving the deductibility of a loss on sale).

28 *See* section 1016.

29 *See* section 1001.

30 *Id.*; *see also* section 165.

31 For a more complete understanding of the opposing view, *see* Letter of American Council of Life Insurers addressed to Jeffrey Van Hove, Tax Legislative Counsel, Office of Tax Policy, Treasury Department, Mark S. Smith, Attorney-Advisor, Office of Tax Policy, Treasury Department, Sheryl Flum, Branch Chief, Branch 4, Office of Associate Chief Counsel, FIP, Internal Revenue Service on *Rev. Rul. 2009-13* (Apr. 20, 2011).

RECENT DEVELOPMENTS IN STATUTORY DEFERRED TAX ACCOUNTING GUIDANCE FOR LIFE INSURERS

By Craig Pichette and Edward L. Robbins

The article "NAIC Adopts SSAP 101—Income Taxes" by Richard Burness and Steven Sutcliffe in the February 2012 edition of *Taxing Times* gave an excellent description of the basic components of SSAP 101. In this article we attempt to emphasize deferred tax issues that actuaries should find insightful. Since year-end 2009, statutory admitted deferred income tax assets have amounted to between 11 percent and 12 percent of statutory surplus industry-wide.[1] This demonstrates that deferred income taxes are an important component of statutory capital. An understanding of the corresponding statutory guidance and the impact of deferred taxes on surplus is important to actuaries charged with managing statutory capital, designing and evaluating insurance products, computing statutory and tax reserves, and performing actuarial projections.

The National Association of Insurance Commissioners ["NAIC"] recently adopted Statement of Statutory Accounting Principles ["SSAP"] No. 101 *Income Taxes a Replacement of SSAP No. 10R and SSAP No. 10*. SSAP 101 was initially exposed in the spring of 2011. Industry representatives had several meetings with the Statutory Accounting Principles Working Group through the summer of 2011. A revised version was re-exposed in August of 2011 and was adopted in the fall of 2011. SSAP 101 is effective on Jan. 1, 2012.

This article will provide a discussion of the theoretical basis of deferred income tax accounting (accounting for actuaries), an overview of the current statutory accounting rules governing income tax accounting under SSAP 101, and some examples of the effects of SSAP 101's admissibility test on regulatory capital. The discussion will include the various deferred tax "corridors" in which a company can find itself, and the boundaries of those corridors.

INTRODUCTION AND BACKGROUND

The concept of deferred taxes has long been recognized as a necessary refinement to the financial balance sheet. Without recognition of deferred taxes, there is no manifestation in the balance sheet of differences in the recognition of statutory and taxable income. Take for example a simplistic fact pattern as follows, for a policy issued at the end of year 1:

Premium income	$120.00
Statutory policy reserve	100.00
Tax basis reserve	90.00

Without accounting for deferred income taxes, the company is relatively "inefficient," with a higher effective tax rate than the marginal tax rate. To wit:

Item No.	Item	Amount	Comments
(1)	Statutory income	$20.00	
(2)	Taxable income	30.00	
(3)	Tax (at 35%)	10.50	
(4)	Effective tax rate	52.50%	[(3)/(1)]

Assume that the policy terminates in year 2, before another premium is paid, with a net surrender value of $85.00. The effective tax rate in year 2 is very low, offsetting the high effective tax rate in year 1:

Item No.	Item	Amount	Comments
(1)	Statutory income	$15.00	Financial reserve released less surrender value paid
(2)	Taxable income	5.00	Tax reserve released minus surrender value paid
(3)	Tax (at 35%)	1.75	
(4)	Effective tax rate	11.67%	[(3)/(1)]

Full recognition of deferred taxes normalizes the tax rate over time. Thus, the impact of recognition of deferred income taxes (without regard to the statutory limitations described below) can be seen by adding the deferred tax asset ["DTA"], equal to

CONTINUED ON **PAGE 18**

35 percent of the $10 difference between financial statement reserves and tax reserves, or $3.50.

Now the result for year 1 is as follows:

Item No.	Item	Amount	Comments
(1)	Statutory income	$20.00	
(2)	Current taxable income	30.00	
(3)	Current tax expense (@35%)	10.50	
(4)	Change in deferred tax	(3.50)	Establish DTA
(5)	Total tax expense	7.00	[(3) + (4)]
(6)	Effective tax rate	35.00%	[(5)/(1)]

The year 2 equivalent result would then appear as follows:

Item No.	Item	Amount	Comments
(1)	Statutory income	$15.00	Financial reserve released less surrender value paid
(2)	Current taxable income	5.00	Tax reserve released minus surrender value paid
(3)	Current tax expense (@35%)	1.75	
(4)	Change in deferred tax	3.50	Release DTA
(5)	Total tax expense	5.25	[(3)+(4)]
(6)	Effective tax rate	35.00%	[(5)/(1)]

In such a situation, deferred taxes serve as the instrument that normalizes the tax expense over time by reflecting in the financial statements the current and future impacts of taxes resulting from current operations. The key concept in deferred taxes is that of a "temporary difference," *i.e.,* the difference between the financial statement basis and the tax basis in an asset or liability that will reverse in the future. In the above example, at the end of year 1, the statutory basis in the policy reserve is $100 while the tax basis in the reserve is $90 due to different rules governing the computation of the required reserve. This difference will "reverse" over time (ultimately, the amount expensed in the financial statements and deducted for income tax purposes will be the amount paid the policyholder), and the difference is thus "temporary." Conceptually, deferred income tax accounting provides financial statement recognition of the future financial benefits or detriments associated with differences in timing in the recognition of income or expense between financial statements and tax returns.

Deferred tax accounting can become rather complex. The accounting models for income taxes adopted for most bases of accounting*, e.g*., U.S. Generally Accepted Accounting Principles ["U.S. GAAP"] and International Financial Reporting Standards ["IFRS"] are what can be characterized as "full" deferred tax accounting models. That is, generally, all deferred tax assets and liabilities are recognized unless specifically excepted, with asset recognition limited in some cases in which it cannot be demonstrated that the asset will be recovered; what U.S. GAAP refers to as a "valuation allowance." The statutory accounting rules also provide a valuation allowance and, as described below, further limit recognition of deferred taxes. The balance of this article will discuss these statutory accounting rules and their evolution over time. Also note that the change in deferred taxes is reflected in the income statement for U.S. GAAP and IFRS purposes. For statutory purposes, the change in deferred taxes is reflected directly in surplus.

In this article we will limit our discussion to those deferred tax assets and liabilities that emanate from single entity temporary differences. Deferred tax aspects of tax sharing agreements between legal entities, foreign taxes, the small life insurance company deduction, and tax credits, among other items, will not be discussed.

SSAP 101 GENERAL REQUIREMENTS

This Statement is effective on Jan. 1, 2012. In addition to guidance on current taxes (not the subject of this Article) it provides new guidance for admissibility of DTAs and DTLs and replaces SSAP 10 and SSAP 10R.

SSAP 101 retains, with modification, the basic three step admissibility criteria of SSAP 10R, renumbering them paragraphs 11 (a), (b) and (c):

- Paragraph 11(a) allows a DTA to be admitted to the extent that temporary differences that reverse within the IRS tax loss carryback provisions, not to exceed a three-year period, can be carried back to recover taxes paid in prior years.
- Paragraph 11(b) provides that a DTA can be admitted to the extent that temporary differences that reverse within

a three-year period can recover taxes to be paid within that period, after application of paragraph 11(a) and subject to certain RBC limits described below.
- Paragraph 11(c) provides that additional DTAs can be admitted to the extent that they can be offset against DTLs.

Significant changes from SSAP 10R include the following:
- The framework for which set of thresholds (percent of Adjusted Surplus and the length of the reversal period) to use for a legal entity changed from a legal entity election (subject to an adequate RBC ratio) in SSAP 10R, paragraph 10(b) to the following framework in SSAP 101, paragraph 11(b):[2]

ACLRBC[3] Ratio	Reversal Period	Percent of Adj. Surplus
Above 300%	3 years	15%
200% to 300%	1 year	10%
Under 200%	0 years	0%

- The surplus values for the "percent of surplus" threshold were changed from the immediate prior reported Adjusted Surplus to the current date Adjusted Surplus.
- The threshold for recognition of income tax contingencies was changed from "probable" to "more likely than not."

Note that the admitted asset calculated under SSAP 101 paragraph 11(a) is not subject to the ACLRBC ratio.

Also, SSAP 101 adds numerous disclosure requirements to the deferred tax process. One element of disclosure concerns Tax Planning Strategies (SSAP 101, paragraphs 13 through 15). In particular, paragraph 22(f) requires disclosure for:

> *The impact of tax-planning strategies on the determination of adjusted gross DTAs and the determination of net admitted DTAs, by percentage and by tax character,[4] and whether the tax-planning strategies include the use of reinsurance-related tax planning strategies.*

ANALYSIS OF THE IMPACT OF CHANGES IN DEFERRED TAXES ON COMPANIES IN DIFFERENT DEFERRED TAX POSITIONS

A life insurance company's deferred tax asset or liability position can have a significant impact on its tax planning. Below are various examples of how tax planning can impact both a company's current tax position and its surplus. For simplicity, assume that the character of DTAs and DTLs matches (such that there would be no issues with offsetting DTAs with DTLs due to character or other limitations), that the company has a sufficient ACLRBC ratio to use the three-year/15 percent limitation described above, and that there is sufficient tax paid within the carryback period or projected to be paid within the three-year reversal period to admit all temporary differences that reverse within the three-year period allowed under paragraphs 11(a) and (b).

Company A:

(a)	Adjusted Gross DTAs	100
(b)	DTAs Admitted through SSAP 101 parags. 11(a) and 11(b)	30
(c)	DTLs	(50)
(d)	Net Admitted DTA/(DTL) as reported	30
(e)	Nonadmitted DTAs	20

Note that the nonadmitted DTA before application of the gross DTLs is equal to 70 (*i.e.*, 100-30). That number is greater than the gross DTL of 50, thus reducing the nonadmitted DTA from 70 to 20. Since that nonadmitted DTA is still a positive value, it does not affect line (b), and thus line (d) remains equal to line (b), at 30.

Company A represents the typical life insurance company. It has a net DTA of $50 (*i.e.*, [(a) – (c)] before application of SSAP 101 admissibility criteria. Life insurance companies typically have DTAs because the tax law applicable to life insurance companies generally results in deferring deductions or accelerating income relative to statutory accounting. The principal examples of this are capitalization of policy acquisition expenses, limitations on deductions for life insurance reserves, and deferral of deductions for accrued expenses such as deferred compensation or pension obligations. However, DTLs can arise from unrealized gains and statutory accrual of bond discount, among other cases.

A life insurance company's deferred tax asset or liability position can have a significant impact on its tax planning.

The company is able to admit $30 of DTAs through paragraphs 11(a) and (b) and an additional $50 under paragraph 11(c). The key component of the calculation is the amount of temporary differences that reverse within three years and may be admitted under paragraphs 11(a) and (b). A company in such a position generally has two alternative means of increasing surplus:

CONTINUED ON PAGE 20

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1. Review the estimates of DTAs that reverse within three years and consider possible tax planning strategies related to this timing. For instance, while some DTA reversals, such as reversal of policy acquisition expenses capitalized under Internal Revenue Code section 848, are mechanical in nature, others involve estimates and judgments that can be refined as better or additional information becomes available. In addition, SSAP 101 allows for consideration of all tax planning strategies, and the use of those that are prudent and feasible to accelerate the reversal of temporary differences.

2. Generate DTLs. Certain transactions decrease current tax expense. The resulting increase in DTLs generally may be offset by unutilized DTAs for a net increase in surplus equal to the reduction in current tax expense. Put differently, in this example, a company could generate $20 more DTLs (*i.e.*, [(a) – (b)-(c)]), and consequently $20 less current tax expense, without any effect on its net admitted deferred taxes, resulting in $20 additional surplus.

All such strategies would, of course, have to be evaluated in the context of the provisions of SSAP 101 addressing recognition of tax benefits.

Company B:

(a)	Adjusted Gross DTAs	50
(b)	DTAs Admitted through SSAP 101 parags. 11(a) and (b)	30
(c)	DTLs	(100)
(d)	Net Admitted DTA/(DTL), as reported	(50)
(e)	Nonadmitted DTAs	0

Note that the gross DTL overwhelms the 50 of DTA in line (a). Simply put, gross DTLs (100) minus gross DTAs (50) result in a 50 DTL as reported.

Company B is in the unusual position of having a net deferred tax liability, which might appear to be unfortunate. Remember, however, that DTLs are generally caused by reductions in current tax expense caused by the deferral of taxable income relative to statutory income. The DTL is simply providing for the reversal of the differences in the future on an undiscounted basis. In this case, increasing the amount of DTAs that reverse within three years and are admitted under paragraphs 11(a) and (b) simply reduces the amount offset against DTLs in paragraph 11(c) by a corresponding amount, with no net effect on surplus. For Company B, unlike Company A, transactions that would further increase DTLs have no net effect on surplus because the decrease in current tax expense is offset by a reduction in surplus associated with the increase in the DTL. On the other hand, transactions that further increase DTAs reduce the net DTL and are offset by a current tax expense with no net effect on surplus up to, in this example, $130 of Adjusted Gross DTA (*i.e.*, [(b) - (c)]) or $80 of incremental DTA. Therefore, increases in DTAs by more than $80 will have a detrimental effect on surplus unless they reverse within three years and are admitted under paragraphs 11(a) or (b).

This is illustrated by the following example:

Adjusted Gross DTAs	130
DTAs Admitted through SSAP 101 parags. 11(a) and (b)	30
DTLs	(100)
Net Admitted DTA/(DTL)	30
Nonadmitted DTAs	0

Note that surplus was increased by a deferred tax benefit of $80 which is exactly offset by a current tax detriment of $80. However, the $80 constitutes a "limit" in this example. If Company B adds $1 to that $80 of incremental Adjusted Gross DTAs, and that $1 does not add to the DTAs admitted through SSAP 101 parags. 11(a) and (b), then Company B would have $131 Adjusted Gross DTA, the same $30 of DTAs Admitted through SSAP 101 parags. 11(a) and (b), and a $1 detriment to surplus considering the current tax expense and no offset in the deferred tax balance. Thus the neutrality "corridor" in this example extends only through the $80 incremental DTA.

CONCLUSION

Actuaries involved in surplus management, modeling and projections, and pricing should understand the marginal effects on surplus of changes in current and deferred tax in order to properly measure and assess the surplus consequences of current management strategies and decisions and assess the potential impact of proposed changes of these strategies. ◂

END NOTES

[1] American Academy of Actuaries, Deferred Tax Asset Bridge Group Report (Revised as of Dec. 13, 2010), p. 32.
[2] Note that separate tables are provided for financial guarantee and mortgage insurers.
[3] Authorized Control Level Risk Based Capital. The ratio equals "Total Adjusted Capital" divided by ACLRBC. Total Adjusted Capital excludes DTAs.
[4] "Ordinary" versus "Capital."

IS IRS CONSENT NEEDED TO CONFORM TAX ACCOUNTING TO A CHANGE IN STATUTORY ACCOUNTING?

By Peter H. Winslow

Life insurance companies are accrual basis taxpayers subject to the same general tax accounting rules applicable to other corporate taxpayers.[1] There are a few exceptions to this general rule. One exception is that accrual accounting does not apply to items that are unique to insurance company accounting, most notably insurance reserves.[2] Another exception is that life insurance companies are not subject to generally applicable accrual rules for original issue discount (OID) or amortization of bond premium.[3] For these items, in general, life insurance companies are entitled to use statutory accounting.

When a life insurance company changes its basis for computing tax reserves, a special 10-year spread rule found in section 807(f) of the Internal Revenue Code applies to the change.[4] But, what happens if the statutory accounting for OID or bond premium changes? Is the company required, or even permitted, to change its tax accounting method to conform with the new statutory accounting method? The answer to this question is determined by identifying the tax accounting method being used by the company and whether there has been a change to that method.

Guidance on whether a change in tax treatment of an item rises to the status of a change in method of accounting can be found in regulations under section 446. The regulations broadly define the term "method of accounting" to include not only the overall method of accounting but also the accounting treatment of any item.[5] This general rule is not very helpful. Fortunately, the regulations provide additional guidance and state that a change in method of accounting includes a change in the overall plan of accounting for gross income or deduction or a change in the treatment of any material item used in such overall plan.[6] 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. Importantly, a change in method of accounting does not include an adjustment in the treatment of an item resulting from a change in underlying facts.[7]

If we can define OID or bond premium as a "material item" and define the accounting method for the item broadly as following statutory accounting, then it can be argued that a change to statutory accounting treatment is merely a change in facts and does not rise to the status of a change in method of accounting. There would be two principal consequences from this conclusion. First, a change in method of accounting can be made for tax purposes only after a request for the change has been made by filing a Form 3115, Application for Change in Accounting Method, and consent to the change from the IRS has been secured.[8] If the accounting method is defined broadly as merely following statutory accounting for the item, then a change for tax purposes to conform with a statutory adjustment would not need IRS approval. Second, when a change in method of accounting is involved, a "section 481 adjustment" may be necessary to reflect the permanent difference that otherwise would occur as a result of the change. As a rule of thumb, the section 481 adjustment is equal to the difference between the accrual or amortization of the item on the new method as compared with the old method as of the beginning of the year of the accounting method change. Under Rev. Proc. 97-27,[9] as modified by Rev. Proc. 2002-19,[10] the true-up adjustment (the positive section 481 adjustment) is spread over four years if it is adverse to the taxpayer. If instead, the company were to conform its OID accrual or bond premium amortization to a new statutory accounting treatment without treating it as a change in accounting, the true-up to the new accounting treatment would presumably be reflected all at once in the year of the statutory change.

A recent Chief Counsel Advice reflects, in analogous circumstances, the IRS's likely rejection of the position that a change in the statutory treatment of an item is not a change in method of accounting. Instead, the IRS probably would contend that such a change requires the IRS's consent for tax conformity. In C.C.A. 201151022 (Dec. 1, 2011), the taxpayer received advance payments for providing bundled products and services to customers under Multiple Deliverable Contracts (MDCs).

CONTINUED ON **PAGE 22**

For financial statement purposes, the taxpayer deferred recognition of the advance payments until all of the products and services had been provided. For tax purposes, the taxpayer had elected to defer recognition of the advance payments under Rev. Proc. 2004-34.[11] That revenue procedure allows deferral of recognition of advance payments provided certain conditions are satisfied, one of which is conformity to the recognition method used on the "applicable financial statement." FASB issued new standards as to how to account for advance payments under MDCs. The taxpayer sought to comply with Rev. Proc. 2004-34 and conform its tax accounting method for advance payments to the new method required by the FASB. The question faced by the IRS Chief Counsel's Office was whether the taxpayer was required to seek the consent of the IRS before making the conforming change because a change in method of accounting would be involved.

The court held that IRS consent for conforming tax accounting to the new ICC standard was not required because this change was not "substantial or material."

The C.C.A. concludes that prior consent of the IRS is required. It cites, and quotes from, regulations[12] that generally provide a taxpayer must obtain the IRS's permission before adopting for tax purposes a change to conform with the taxpayer's new book method of accounting:

> Except as otherwise provided in Chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or permitted under the Internal Revenue Code or the regulations thereunder.

The IRS can be expected to take a similar position for a life insurance company's change in statutory reporting and require prior consent to a conforming change for tax purposes. Nevertheless, there is some authority for the position that such consent would not be required in all circumstances. In *Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States*,[13] the Interstate Commerce Commission (ICC) changed its accounting requirements for purchases of property by railroads. The ICC's previous requirement for property acquisition costs was to expense them if the cost was less than $100. The ICC raised the expensing threshold to $500. The court held that IRS consent for conforming tax accounting to the new ICC standard was not required because this change was not "substantial or material." The court noted that the change had only a very slight effect on the taxpayer's net income and the ICC adopted the new accounting standard as a result of a change in the overall industry's circumstances (a change in facts).

It may be possible to rely on the rationale of the *Cincinnati, New Orleans and Texas Pacific Railway* case to avoid filing a Form 3115 with the IRS where the change to statutory accounting would have a minimal current tax effect. However, if the change would cause a significant section 481 adjustment, seeking the IRS's consent is probably required, and also advantageous. As discussed above, a change to statutory accounting treatment that is not a change in method of accounting would presumably require that the true-up to the new accounting treatment be reflected wholly in the year of change. This would not be the case, however, if a change in method of accounting is involved and the section 481 adjust-

ment would increase taxable income. Then, the adverse true-up adjustment is spread over four years. As a result, although it may be inconvenient to treat changes in statutory treatment as an accounting method change and file a Form 3115 seeking the IRS's consent before making the change, it actually may be more favorable to do so.

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END NOTES

[1] I.R.C. § 811(a).
[2] *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).
[3] I.R.C. § 811(b).
[4] See Peter H. Winslow & Lori J. Jones, Change in Basis of Computing Reserves – Is It or Isn't It?, *Taxing Times*, Feb. 2010.
[5] Treas. Reg. § 1.446-1(a).
[6] Treas. Reg. § 1.446-1(e)(2)(ii)(a).
[7] Treas. Reg. § 1.446-1(e)(2)(ii)(b).
[8] I.R.C. § 446(e).
[9] 1997-1 C.B. 680.
[10] 2002-1 C.B. 696.
[11] 2004-1 C.B. 991.
[12] Treas. Reg. § 1.446-1(e)(2)(i).
[13] 424 F.2d 563 (Ct. Cl. 1970).

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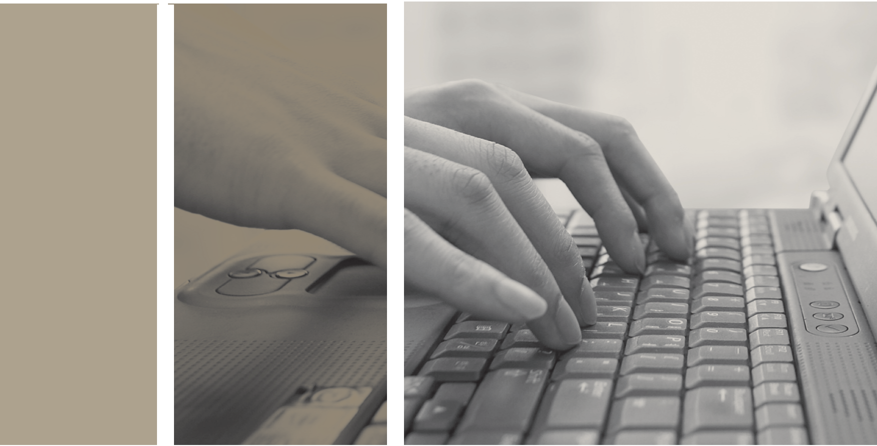

IRS THIRD-PARTY SUMMONSES—NEGOTIATED COOPERATION USUALLY IS THE BEST APPROACH

By Samuel A. Mitchell

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Over the last several years many life insurance companies have received third-party administrative summonses from IRS agents seeking documents and information concerning life insurance policies sold to trusts and individual taxpayers. Most of these summonses arise in the context of trust arrangements the IRS considers abusive. The summonses typically arise in two types of IRS examinations – (1) income tax examinations of the individual taxpayers who participated in the arrangements and (2) promoter penalty examinations of the agents or brokers.

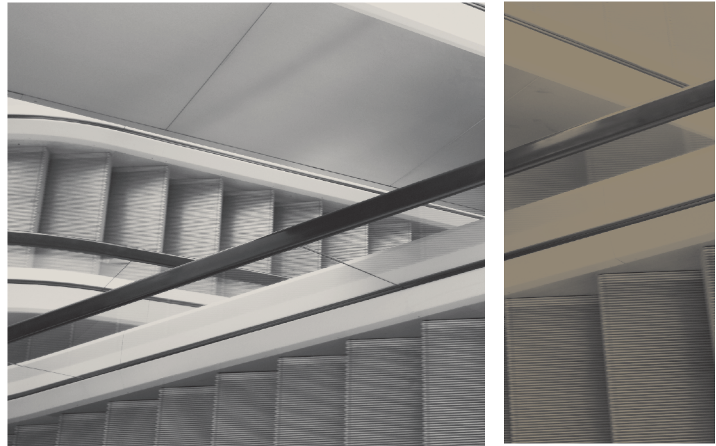
An IRS third-party summons, and particularly one issued in promoter examinations, can be very costly and burdensome. For example, the summons may request detailed information over a period of many years regarding everything from actuarial and reinsurance documents and information to all types of communications with the promoter. An IRS summons is not self-enforcing. If the company refuses to comply, however, the IRS can go to Federal District Court to seek enforcement. There are legal remedies available to a third-party summons recipient in Federal District Courts; however, the IRS has specific statutory authority under I.R.C. § 7602 to issue such a summons and the courts generally have not been kind to recipients who resist. These summons enforcement actions in court can be time-consuming and costly. Therefore, satisfaction of the IRS's request for information outside of court in the most cost-effective manner is usually the best course.

There are a number of things to think about when a company receives a third-party summons, such as privileged and proprietary information, ongoing lawsuits filed by policyholders, and the effect of document production on the company's relationships with agents, brokers and policyholders. Although the deck is stacked in favor of the IRS in obtaining all non-privileged information demanded in the summons, most IRS agents will be cooperative if the situation is handled properly. The IRS agents do not want to be overwhelmed with paper and, perhaps more importantly, operate under timing and budgetary restrictions that incentivize them to be reasonable. The best approach for the company in terms of managing both its costs and external risks is to cooperate with the IRS agents within the scope of their limitations and attempt to negotiate a process that will result in a more limited compliance burden.

Editor's Note: *This article was originally printed in* Expect Focus*, Volume II, Spring 2012, a publication of Jorden Burt LLP, and is reprinted in* Taxing Times *with permission.*

ACLI UPDATE
FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

By Mandana Parsazad, Pete Bautz, Walter Welsh and James Szostek



On April 23, 2012, ACLI submitted a comment letter on the proposed regulations to implement the Foreign Account Tax Compliance Act ("FATCA"). The letter provides, in detail, recommendations that identify critical changes for the government to consider in devising life insurance-specific rules; it also requested clarification of the life insurance-specific rules and recommended approaches to assist the government and the industry in Chapter 4 enforcement and compliance. We requested that new categories of deemed-compliant companies be provided so that life insurers could comply with FATCA, and we recommended that the rules for Controlled Foreign Corporations ("CFCs") and retirement funds be modified to address FATCA's purpose and reduce compliance costs. Specifically we requested:

- Life insurance companies in jurisdictions where local law prohibits the transmittal of personal information as required by Chapter 4, and for which an Intergovernmental Agreement ("IGA") is not in place, should be provided an exemption from Chapter 4 until such time as the U.S. government reaches a solution with such foreign government(s) to address the local law prohibitions.
- Life insurance companies that are Foreign Financial Institutions (FFIs) should qualify as registered deemed-compliant with the requirements under Chapter 4 if they have procedures in place that prohibit them from selling to, and if they do not market policies to, persons who are not residents in the jurisdictions where they are licensed to operate. The final regulations should include a deemed-compliant category for insurance companies; we provided a list of conditions that would enable an insurance company to qualify as deemed-compliant.
- An additional category of deemed-compliant FFIs should be included in the final regulations to address insurance FFIs that exist only to service closed blocks of life insurance and annuity contracts where the companies no longer issue any new policies.
- Life insurance and annuity contracts acquired in a merger or acquisition should be classified in the same manner as pre-existing contracts and not subject to Chapter 4 rules retroactively even if the acquiring company has already entered into an FFI agreement.
- Foreign life insurance companies that are classified as CFCs should be treated as having complied with their reporting obligations under the IRC if they fulfill requirements under Chapter 4. We requested that the provisions under 6041 and 6049 related to the current information reporting rules be modified so they conform to the Chapter 4 presumptions of non-U.S. person status unless objective U.S. taxpayer indicia becomes apparent in the ordinary course of business.
- The registered deemed-compliant requirements for retirement funds should be modified to encompass Privatized Government Pension Plans where no single beneficiary has the right to more than 5 percent of the FFI's assets or the FFI assets are held solely for a participant in a government designed broad-based pension system.

We also recommended changes to definitions and guidelines proposed in the rules; in particular we recommended:

- The definitions of annuities and life insurance contracts should be clarified to state that for the purposes of Chapter 4, a contract is an annuity or a life insurance contract if it is regulated as an annuity or a life insurance contract in the jurisdiction where the contract is issued.
- The definition of cash value insurance contracts should be defined as the amount that a policyholder is entitled to receive upon the termination or surrender of the contract.
- The scope and definition of term life insurance contracts should include life insurance contracts that provide coverage for a stated duration and the amount paid upon termination cannot exceed aggregate premiums paid for the contract.
- Indemnity reinsurance contracts should be excluded from the definition of a financial account. The account holder of this type of account is not an individual but rather an insurance company or a reinsurance company engaging in normal risk transfer transactions in the ordinary course of business. This type of contract does not allow for an in-

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dividual or a non-insurance entity to invest in the account. We requested clarification that indemnity reinsurance is excluded and request that such contracts expressly be exempted from the definition of a financial account.
- The definition of life insurance and annuity contracts that qualify as grandfathered obligations should be clarified to indicate that the definitions include life insurance contracts that are payable upon surrender or death and annuity contracts whose term-certain includes lifetime payouts.
- There should be a $50,000 de minimis threshold provided for all cash value insurance contracts issued after the date of the Foreign Financial Institution ("FFI") agreement. This carve-out, currently provided only for depository accounts, would provide relief to many insurance companies that only issue low cash value insurance products.
- The requirement for review of documentary evidence every three years should be eliminated and replaced by a requirement to review documentary evidence when a change in circumstances revealing objective indicia of U.S. taxpayer status occurs.
- Some restrictions surrounding the exclusion of pension and retirement accounts should be modified or removed to provide meaningful relief for such accounts. The $50,000 annual contribution limit and the restriction of contributions of earned income to retirement accounts should be removed from the final regulations.

ACLI and its member company representatives continue to discuss the industry's comments and identify additional topics with the U.S. Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") officials as the government considers the final rules to adopt in implementing FATCA.

The required minimum distribution rules had the potential to frustrate the use of longevity annuities in qualified plans and IRAs.

PRINCIPLE-BASED RESERVES

In a letter to the Internal Revenue Service and Treasury dated May 1, 2012, the ACLI requested that the Service include on its Guidance Priority List for 2012-2013 numerous items of critical interest to life insurers. One item reflected in the ACLI letter was a request for guidance on tax issues arising under § 807 of the Internal Revenue Code as a result of the adoption by the National Association of Insurance Commissioners ("NAIC") of a principle-based approach to certain life insurance reserves. The ACLI had made a similar request for inclusion of this item on the IRS 2011-2012 Guidance Priority List.

The NAIC's Life Actuarial Task Force vote to expose the NAIC Valuation Manual on June 19, 2012, represented an important step in the NAIC's consideration of PBR and an appropriate juncture for ACLI and Treasury/IRS to continue their dialogue on PBR tax guidance. Discussions will cover further Treasury/IRS consideration of the PBR tax issues first addressed in Notice 2008-18.

ACLI will update *Taxing Times* readers as events unfold.

LONGEVITY ANNUITIES: COMING SOON TO YOUR RETIREMENT PLAN OR IRA

Longevity annuities provide income starting later in retirement. Also known as longevity insurance, payments under these deeply deferred payout or income annuities typically begin on or before age 85 on either a single or joint lives basis. The required minimum distribution rules had the potential to frustrate the use of longevity annuities in qualified plans and IRAs. Under these rules, payments must commence from qualified plans, including 401(k), 403(b), and governmental 457(b) plans, and IRAs starting at age 70½ (or, if later, retirement for most participants in qualified plans). These minimum payments are determined based upon the total account balance held in the plan or IRA(s) as of the prior calendar year-end, including the value of any annuity contracts that are not yet in pay status. Without specific guidance there is a concern that a longevity annuity in qualified plans or IRAs would require greater proportional distributions from the remaining assets that could deplete the plan or IRA account even as annual tax liabilities continue to accrue. ACLI and its members have been seeking additional guidance and legislation to resolve these concerns.

On Feb. 3, 2012, Treasury and IRS proposed regulations to exclude certain annuity contracts from the minimum distribution rules.[1] To qualify for the proposed exclusion, the contract must be a "qualifying" longevity annuity contract or "QLAC." A QLAC is an annuity contract (other than a variable annuity, an equity indexed annuity or similar contract) in which:

- Payments commence no later than age 85.
- The contract satisfies the generally applicable minimum distribution requirements, for example, the limitation on increasing payments.
- The contract does not provide a cash surrender value or similar feature.
- The only benefit payable to a beneficiary is a life annuity.
- The contract states that it is intended to be a QLAC.

Limitations. There is a limit to the amount of QLAC an individual may purchase under the proposed rule. The QLAC exclusion is lost if premiums are in excess of either of these limits:

> Plan/IRA Percentage Limit: Premiums paid may not exceed 25 percent of the individual's account balance on the date of payment (reduced by the amount of any previous QLAC purchased). This limit applies separately to each qualified plan. For traditional IRAs, the limit applies to the aggregate of all of the individual's traditional IRA account balances.
>
> Individual Dollar Cap: An individual's total QLAC premiums under qualified plans and IRAs cannot exceed $100,000.

Example: Pat is a participant in a 401(k) plan and also has 2 IRAs. On Dec. 31, 2012, Pat has $100,000 in the 401(k) plan, while each of Pat's IRAs has $20,000. In 2013, Pat may purchase a QLAC with no more than $25,000 under the 401(k) plan (25 percent of $100,000) and a QLAC with no more than $10,000 under an IRA (25 percent of $40,000). These QLAC premiums of $35,000 are less than the $100,000 individual dollar cap.

Treasury and IRS have gathered public comments and held a public hearing on the proposal, and they seem intent on considering changes to make these rules workable for taxpayers, plans and IRA providers. While there may be changes to the limitations in the final rule, expect to see Treasury and IRS retain a percentage limit.

In the preamble to the proposed regulation, Treasury and IRS note that a percentage limitation is necessary in order to be consistent with the pattern of minimum payments required over the life or life expectancy of participants as implemented under the current regulations. They note that the 25 percent limit ensures an overall pattern of payments from the remaining account balance and the longevity annuity that does not provide more deferral than would otherwise be available under the current regulations. Continued efforts on legislative proposals to allow even greater use of longevity annuities is also expected. ◂

END NOTES

[1] For an in-depth discussion of the provisions of the proposed regulation, readers are referred to the article in the May 2012 issue of *Taxing Times*. *See*, Christian DesRochers, Proposed Regulation to Accommodate Longevity Annuities in Retirement Plans, *Taxing Times* (May 2012).

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T[3]: *TAXING TIMES* TIDBITS

IRS RULES ON NOTICE AND CONSENT REQUIREMENTS FOR EMPLOYER-OWNED LIFE INSURANCE POLICIES

*By Kyla Grogan and Frederic Gelfond**

In LTR 201217017, the Internal Revenue Service (IRS) issued guidance regarding the application of the employer-owned life insurance notice and consent requirements contained in Internal Revenue Code section 101(j).[1] That section generally provides that the exclusion of death benefits under an employer-owned life insurance contract is limited to the aggregate premiums or other consideration paid for the contract. Such limit on excludability would not operate, however, if the insured or the payments under the contract qualify for one of the exceptions set forth in section 101(j)(2). In order for the exceptions in section 101(j)(2) to apply, however, the notice and consent requirements contained in section 101(j)(4) must be satisfied.

The taxpayer in LTR 201217017 requested a ruling that, pursuant to Notice 2009-48,[2] the IRS would not challenge the application of section 101(j)(2) to its employer-owned life insurance contracts because the taxpayer made a good faith effort to comply with the section 101(j)(4) notice and consent requirements. In considering the information provided, however, the IRS determined that the taxpayer had actually satisfied, and not merely made a good faith effort to comply with, the notice and consent requirements of section 101(j)(4).

Background on the Law and Current Guidance under Notice 2009-48

Section 101(j) was added to the Internal Revenue Code by the Pension Protection Act of 2006,[3] and generally applies to employer-owned life insurance contracts issued after August 17, 2006. Section 101(j) provides that the exclusion of employer-owned life insurance proceeds from income is generally limited to the aggregate premiums or other consideration paid, unless one of the following exceptions set forth in section 101(j)(2) is met and the notice and consent requirements of section 101(j)(4) are satisfied:

- The insured was an employee of the taxpayer at any time during the 12 months before death;
- The insured was a director, highly compensated employee, or highly compensated individual at the time the contract was issued; or
- The amount received upon the insured's death was distributed as follows:
  - Paid to a member of the insured's family, the insured's designated beneficiary (other than the taxpayer), a trust established to benefit a member of the insured's family or the designated beneficiary, or the insured's estate; or
  - Used to purchase an equity, capital, or profits interest in the taxpayer from any of these persons (described immediately above).

The notice and consent requirements of section 101(j)(4) that the employer must satisfy before the issuance of the contract include the following:

- The taxpayer must notify the employee in writing that it intends to insure the employee's life and of the maximum face amount for which the employee could be insured;
- The taxpayer must notify the employee in writing that the taxpayer will be the beneficiary upon the employee's death; and
- The employee must provide written consent to being insured and that the coverage may continue after employment terminates.

In Notice 2009-48, the IRS provided guidance on section 101(j), including the notice and consent requirements of section 101(j)(4), in a series of questions and answers. In question and answer 13, the IRS provided that it will not challenge an exception under section 101(j)(2) if the taxpayer satisfies the following three conditions:

(1) The taxpayer made a good faith effort to satisfy the notice and consent requirements;
(2) The taxpayer inadvertently failed to satisfy the requirements; and
(3) The taxpayer discovered and corrected the failure no later than the due date of its federal tax return for the taxable year in which the contract was issued.

The Facts of This Matter . . .

As discussed in the ruling, the taxpayer, a closely-held corporation, entered into a signed agreement with each of its employee shareholders that provided that the taxpayer would purchase the shareholder's interest in the taxpayer in the event that the shareholder died or terminated employment with the taxpayer. The agreement provided that the taxpayer intended to obtain life insurance on each shareholder's life in order to facilitate such a purchase and that the taxpayer would be the owner and beneficiary of the life insurance. The agreement also provided that if the agreement was terminated or the shareholder disposed of its interest in the taxpayer, the shareholder would have the right to purchase the life insurance policy from the taxpayer; if the insurance contract was not purchased, the taxpayer would retain the right to surrender or dispose of the insurance.

In order for the taxpayer to purchase the life insurance contracts, each shareholder completed a signed application that indicated that the taxpayer would be the beneficiary of the insurance contract and provided the amount of coverage that would be obtained. The taxpayer provided and obtained separate documentation from each shareholder that was intended to satisfy the notice and consent requirements of section 101(j)(4), but not until after it purchased the contracts and after the due date of its federal income tax return for the year of purchase.

The taxpayer requested a ruling that, pursuant to Notice 2009-48, the IRS would not challenge the application of section 101(j)(2) to the life insurance contracts because it made a good faith effort to comply with the notice and consent requirements of section 101(j)(4).

The IRS Conclusion

The IRS considered the taxpayer's documentation as a whole and determined that all of the notice and consent requirements of section 101(j)(4) were satisfied before the contracts were issued. Although no one separate document satisfied all the notice and consent requirements, the taxpayer provided all the required information to shareholders through the combination of the agreement and the application, both of which the shareholders signed before the contracts were issued and the taxpayer filed its return for the year of purchase of the contracts. Nevertheless the taxpayer appears to have sought relief through guidance that it acted in good faith in accordance with the provisions of Notice 2009-48 question and answer 13. Despite the specific ruling request made by the taxpayer, however, the IRS did not need to consider whether the taxpayer's facts satisfied the good faith criteria set forth in the notice. This is because there was no failure in the first instance, as the provisions of section 101(j) had already been satisfied.

The ruling reflects a reasonable approach towards determining whether a taxpayer has satisfied the statutory notice and consent requirements of section 101(j)(4).

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END NOTES

[*] The authors thank Deloitte Tax senior manager, Yvonne Fujimoto, for her assistance in drafting this article. This article contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this article.

[1] Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] 2009-1 C.B. 1085.

[3] P.L. 109-280.

CONTINUED ON **PAGE 30**

THE IRS RULES AGAIN ON AN ANNUITY-LTC COMBINATION PRODUCT

By Brian King

On Dec. 20, 2011, the Internal Revenue Service (IRS) released PLR 201213016, which addresses whether a noncancellable long-term care (LTC) rider offered with a single premium deferred annuity contract is an "insurance contract" for purposes of section 7702B(b)(1) of the Internal Revenue Code. This ruling is the third private letter ruling issued by the IRS that addresses certain federal income tax aspects of LTC annuity combinations. The IRS previously issued PLR 200919011 dealing with a coinsurance design[1] (see September 2009 issue of *Taxing Times*) and PLR 201105011 dealing with a tail design[2] (see May 2011 issue of *Taxing Times*) (the *Prior Rulings*). What is noteworthy with PLR 201213016 is that the IRS declined to rule on the insurance company's request that the investment in the contract (within the meaning of section 72) of the annuity contract not be reduced by the payment of an LTC benefit.

Facts of the Ruling

Similar to the LTC annuity combination that was the subject of PLR 201105011, the LTC Rider that is the subject of this ruling is also a tail design LTC rider. All LTC benefits during the initial benefit payment period (subject to elimination and waiting period requirements) are offset dollar for dollar by reductions to the annuity contract's cash value, referred to as Phase I in the ruling request. A second benefit period, Phase II, begins once the benefits during Phase I have been exhausted, assuming the insured is still eligible for benefits. Regardless of whether benefits are payable during Phase I or II, the contract limits the monthly benefit payment to the lesser of a defined monthly benefit cap or actual expenses incurred for qualified long-term care services during the period the insured is chronically ill.

The insurer imposes a monthly charge for the LTC Rider that is expressed as a percentage of the contract value of the annuity. The rate of the rider charge cannot be increased, and will decrease if the imposition of the charge would cause the value of the annuity contract at the end of the month to be less than the value at the end of the prior month. The rider charge is paid with after-tax dollars and reflects an arm's length charge for the LTC Rider.

Requested Rulings

The insurer requested the following rulings from the IRS:

1. The LTC Rider constitutes an insurance contract within the meaning of section 7702B(b)(1);
2. All LTC benefits will be excludable from the policy owner's gross income under section 104(a)(3); and
3. The investment in the contract (within the meaning of section 72) of the annuity contract to which the LTC Rider is attached will not be reduced by the payment of LTC benefits.

With respect to the first ruling request, the IRS concluded that the LTC Rider constitutes an "insurance contract" within the meaning of section 7702B(b)(1). The analysis presented by the IRS was largely consistent with the Prior Rulings, focusing on the presence of the risk shifting and risk distribution, and that the LTC Rider conforms to the definition of insurance in the commonly accepted sense.

The second ruling request deals with the tax treatment of LTC benefits received by the policy owner. Because the LTC Rider constitutes an insurance contract under section 7702B(b)(1) (based on the first ruling request) and the insurer requesting the ruling represented that the LTC Rider otherwise satisfies the requirements for a QLTCI contract under section 7702B, the IRS ruled that the LTC benefits would be excludable from gross income under section 104(a)(3).

While there is nothing surprising with the first two rulings, the IRS declined to issue a ruling on the third request, dealing with the effect that the payment of the LTC benefit has on the section 72 "investment in the contract" for the annuity contract. Interestingly, the IRS did rule on a similar request in PLR 200919011. In LTR 200919011, the IRS concluded that "payment of LTC Benefits under the Rider will reduce the 'investment in the contract' of the [annuity contract] for purposes of § 72," without elaborating on how the investment in the contract would be reduced. The ruling was not received favorably by the industry, prompting responses by industry groups to the IRS to reconsider the position taken in the ruling. The IRS may still be formulating its thoughts on this matter as evidenced by the release of Notice 2011-68 in August of 2011. Notice 2011-68 addressed certain aspects of the tax treatment of stand-alone and combination LTC insurance products, providing interim guidance on certain issues relating to the determination of the investment in the contract for annuity-LTC combinations. The Notice was silent, however, on how the

tax-free LTC benefits received under the QLTCI portion of an annuity-LTC combination product affect the investment in the contract for the annuity portion of the contract. (The same issue also exists for life-LTC combination products.) Perhaps the IRS's decision not to issue a ruling on the effect of an LTC benefit payment on the annuity portion's investment in the contract provides an indication that more formal guidance on this matter may be forthcoming.

END NOTES

[1] Under a coinsurance design, each LTC benefit results in a reduction in the annuity cash value but in part consists of net amount at risk. The reduction in the annuity cash value is typically a predetermined percentage (less than 100 percent) of the LTC benefit payment.

[2] Under a tail design, all LTC benefits that are payable during an initial period result in a dollar for dollar reduction in the annuity cash value. When the benefits during the initial period are exhausted, LTC benefits continue for a period of time, without reduction to the annuity cash value, *i.e.*, they consist solely of net amounts at risk.

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