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AG 38, ULSG AND THE SPIRIT OF XXX

By Kristin Norberg

Actuarial Guideline XXXVIII (The Application of the Valuation of Life Insurance Policies Model Regulation, herein referred to as "AG 38") has an extensive history, resulting in part from the diverging efforts of "innovative" product designers on the one hand and "conservative" state regulators on the other.[1] The guideline was introduced by the National Association of Insurance Commissioners' (NAIC's) Life and Health Actuarial Task Force (since renamed the Life Actuarial Task Force, or LATF) during 2002 in order to demonstrate reserving approaches that would comply with the Valuation of Life Insurance Policies Model Regulation (known as Regulation XXX) for various policy features that constitute guarantees.[2]

AG 38 begins with a reference to "common sense … professional responsibility … [and] compliance with both the letter and the spirit of the law," all concepts that LATF chose to emphasize in the context of the product innovations of the early 2000s.[3] As companies have continued to innovate since then in efforts to make low-cost guaranteed coverage available to consumers, the NAIC and LATF have responded by continuing to elaborate upon the underlying principles and "spirit" of XXX and AG 38. In 2005 and 2006, the guideline was expanded to reflect specific product assumptions, lapse assumptions, and a stand-alone asset adequacy analysis for UL contracts with secondary guarantees (ULSG). The latest installment of the guideline, adopted by the NAIC on Sept. 12, 2012,[4] expands the ULSG requirements to incorporate the deterministic reserve under principle-based reserves (PBR),[5] a stand-alone Actuarial Memorandum, reporting related to reinsurance transactions, collection and review of all related memoranda by the NAIC's Financial Analysis (E) Working Group (FAWG), and even specific requirements for the design and filing of new ULSG products.

With these revisions, AG 38 now has five subsections, 8A through 8E, that apply to ULSG policies issued in various time periods. Section 8D of the latest update also introduces a variation by statutory reporting years for some blocks of business. Since the Internal

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FROM THE EDITOR

TO OUR READERS

By Christian DesRochers

In this issue, we present articles on a variety of topics, with a particular focus on reserve-related issues. We welcome Kristin Norberg as a first-time author, an informative discussion of the tax issues related to the ever-evolving reserve standards under Actuarial Guideline 38 (AG 38). We also present an exchange of views between Ed Robbins and Peter Winslow on the *American Financial* case, as well as a continuation of our ongoing series on discussions related to principle-based reserves. I am joined in that conversation by Mark Smith and Peter Winslow.

As reserve standards continue to evolve, it is becoming increasingly difficult to reconcile the developments in statutory reserves with the standards for federally prescribed reserves under section 807. It has long been recognized that a key problem in determining an equitable tax base for life insurance companies was clearly related to reserve deductions. This tension was expressed in the 1958 legislative history:

> Various methods have been used, or suggested, as devices for measuring the appropriate size of the reserve deduction. Probably the most obvious would be to permit each company to deduct its own additions to reserves…. The experience with varying formulas for determining reserve requirements has suggested to many that an individual company basis for determining needs is desirable, but only if some method is determined which for tax purposes does not vary additions to reserves depending on whether a company has established its reserves on liberal or conservative basis.[1]

Under the 1959 Act, Code Section 810(c) (Phase II) permitted a deduction for "life insurance reserves (as defined in section 801(b)." The 10-year spread (now section 807(f)) was included as a control over changes in reserve assumptions.

In congressional testimony in 1983, John E. Chapoton, assistant secretary (Tax Policy) explained that the use of state law reserves allowed "life insurance companies to accelerate deductions for additions to reserves." He went on to comment:

> We [Treasury] suggest that for tax purposes, the highly conservative state regulatory assumptions result in an undue acceleration of deductions. Moreover, we question whether life insurance companies should ever be allowed to compute reserves under assumptions more pessimistic than the state regulators require to be used.[2]

The system that was ultimately adopted was the current section 807 system, which introduced the concept of federally prescribed reserves, provided a parallel tax reserve system to the statutory reserve system as it existed in 1984, using prescribed interest and mortality and the reserve method (as of the date of issuance). The introduction of the applicable federal interest rate (AFIR) in 1988 resulted in tax reserves that were less than the statutory minimums because of the higher interest rates. However, under the current AFIR rates, tax reserves and statutory minimum reserves are generally equal. Arguably, the most significant difference

between statutory and tax reserves are items that are generally considered non-deductible, including asset adequacy and stochastic reserves. Although as we address our discussion of PBR, Congress looked to the National Association of Insurance Commissioners (NAIC) for reserve method, the basic structure of section 807 is "frozen in time" at the reserve method in effect in 1984 based on an individual policy model of formulaic reserves, with specific parallel statutory and tax assumptions.

Given recent developments, including the proliferation of actuarial guidelines and the emergence of principle-based reserves as well as the recent litigation that has been well documented in *Taxing Times*, this is an opportunity to reflect on the current tax reserve system. Some thoughts to consider:

- Do the limitations imposed on statutory reserves based on the method by which the reserves are calculated reflect congressional intent under the 1984 Act?
- To the extent that the reserve deduction is a revenue measure, does the cost to administer the system from the perspective of both the government and the life insurance industry justify the additional revenue that is raised?
- Would a return to the 1959 Act system of permitting the deduction of statutory reserves, combined with a section 807(f) spreading of changes in reserve basis, simplify the system for both the taxpayers and the government?
- Would the section 832 approach that reserves for unpaid losses must be "a fair and reasonable estimate of the amount that the company will be required to pay" be workable for life insurance reserves?[3]

One thing that is certain is that this will not be the last time we address tax issues related to life insurance reserves.

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.

END NOTES

1. Report on the Taxation of Life Insurance Companies, Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, Dec. 31, 1958, 4-5.
2. Tax Treatment of Life Insurance, Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 98th Cong. 1st Sess., Serial 98-39, 50 (1984).
3. See Treas. Reg. § 1.832-4(b).

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FROM THE CHAIR
COMING AND GOING

By Mary Elizabeth Caramagno

I just returned from the 2012 Society of Actuaries (SOA) Annual Meeting in Maryland. The annual meeting is my favorite SOA meeting to attend, because it's full of the excitement and optimism that comes with a new year and new opportunities. I'm honored to be the new chair of the Taxation Section Council.

The council had its annual face-to-face meeting in National Harbor, and I'm excited about our plans for the coming year. Brenna Gardino will be the new vice chair of the section. I'd also like to welcome the newly elected members of the council: Tim Branch, Kristin Norberg and Jim VanEtten. Kristin is a member of the *Taxing Times* editorial board. Tim and Jim have jumped into the section's activities with both feet, volunteering to be our Life & Annuity Symposium liaison and our secretary/treasurer, respectively.

At the meeting, we reluctantly said goodbye to our outgoing council members Ame Biggart, Dan Theodore and Kristin Schaefer. Among other things, Ame has represented the Taxation Section on the Annual Meeting Planning Committee. Dan has had a multiyear stint as the section's secretary/treasurer, keeping our meeting minutes and handling our finances. Last, but not least, Kristin is the outgoing chair of the section. Under Kristin's leadership, we presented a successful Product Tax Seminar, as well as several sessions at each of the Life & Annuity Symposium, the Valuation Actuary Symposium and the annual meeting.

Looking ahead, we've already begun to plan our educational offerings for 2013. We'll have a number of face-to-face educational opportunities. In May, we plan to offer a hot breakfast and two sessions at the Life & Annuity Symposium in Toronto. Immediately following that meeting, we will offer a §7702/7702A Boot Camp. In the fall, the section will, as usual, be well represented at both the Valuation Actuary Symposium and the annual meeting.

This year we also plan to expand our technology-based initiatives. Webinars are a great way to provide timely updates on "breaking news" from the Internal Revenue Service (IRS). We're expecting IRS guidance on some important topics and will schedule webinars as soon as the guidance is released. Podcasts are a relatively new technology for the SOA's sections, and Dan Theodore has kept the Taxation Section on the cutting edge by recording several that are already available on the SOA website. We're looking forward to posting additional podcasts and appreciate Dan's hard work behind the scenes to prepare them. Finally, we've formed a LinkedIn group to generate conversation and keep everyone informed about the section's activities. To become a member of the Taxation Section LinkedIn group, you must first join the broader SOA group.

The jewel in our crown is our section newsletter, *Taxing Times*. We mail nearly 900 copies of each issue to section members and other interested parties, and a comparable number are downloaded from the SOA website. We also plan to record individual articles as podcasts. If you'd like to volunteer to help in that effort, please contact me or Dan Theodore.

Speaking of volunteers, there are many ways to get involved with the section. We need volunteers to write articles for *Taxing Times*, to speak at meetings, to develop webinars, and to suggest or participate in research opportunities. If you want to get involved but don't know how, contact me or another council member and we'll help you get plugged in. Help us make 2013 another great year!

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Revenue Code (IRC) Section 807(d)(3) defines the tax reserve method to be "the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract,"[6] the complex generational structure of AG 38 results in an array of applicable methods for determining the federally prescribed reserve (FPR) for a ULSG contract. This article will present a brief history of the situation and discuss some of the key challenges for tax practitioners as they consider the AG 38 revisions.

THOSE INNOVATIVE ACTUARIES

Actuaries responsible for statutory and tax reserve valuation at most companies in the ULSG marketplace need to deal with several generations of product design, each having issue dates that may or may not coincide with the generational changes in the AG 38 language. In general, a product with a "secondary guarantee" provides that a policy will remain in force at the original schedule of benefits if the stated secondary guarantee conditions are met, which may involve either payment of a specified premium or sufficient funding of a side "shadow" fund, depending on the design.

The earlier, specified premium design clearly came under the scope of Section 7 of Regulation XXX, which sets valuation standards for flexible and fixed-premium UL policies with secondary guarantees.[7] Shadow accounts presented a somewhat more complex situation, though. A shadow account operates like a typical UL fund value except with different charges and credits that are generally more favorable than the guaranteed charges and credits in the base policy. Since the objective is to provide death benefit coverage beyond the period for which the benefits would be available at a given funding level under the base policy, shadow accounts do not provide an additional cash benefit. There were conflicting viewpoints initially about whether XXX applied to shadow account products, since the regulation does not describe the design itself but rather refers to "a policy in which the minimum premium at any duration is less than the corresponding one year valuation premium" at defined assumptions.[8]

AG 38 confirmed that shadow accounts were indeed within the scope of XXX, with that clarification also applicable to policies issued in prior years starting from the adoption of XXX.[9] Prospectively, AG 38 defined a nine-step approach for calculating ULSG reserves that reflects the extent to which the shadow account or specified premium guarantee has been pre-funded by the policyholder. An abbreviated description of the generic steps of this "Example 8 approach" follows:[10]

> Steps 1–2. Calculate minimum gross premiums for the secondary guarantee, and use those for the initial XXX basic (Section 7B) and deficiency (7C) reserves. Call this XXX_{7B+7C}.
>
> Steps 3–4. Calculate the funding ratio, based on actual pre-funding relative to fully funding the remaining secondary guarantee (on a single-premium or paid-up basis).
>
> Step 5. Calculate the net single premium under statutory mortality and interest standards for the remaining secondary guarantee period. Call this NSP_{SG}.
>
> Steps 6, 8. Use the funding ratio (indirectly restricted to be between 0 and 1)[11] to establish the total AG 38 Example 8 reserve at a point in the "corridor" between the XXX_{7B+7C} floor and the NSP_{SG} cap, and then subtract surrender charges, as follows:
>
> TotalEx.8reserve=XXX_{7B+7C}+(fundingratio*[NSP_{SG} – XXX_{7B+7C}]), less the surrender charge actually applicable (*i.e.*, account value minus surrender value).

Steps 7, 9. If the resulting total Ex. 8 reserve is greater than the initial XXX_{7B+7C} reserves, then reallocate between deficiency and basic amounts as follows:

> Final (reduced) deficiency reserve = initial XXX_{7C} * (1 – funding ratio).
>
> Final basic reserve = total Ex. 8 reserve – reduced deficiency reserve.

After completing these steps, the actuary would adjust for any catch-up provisions according to Section 7 of AG 38 and then return to XXX Section 7D to apply a floor at the normal UL Commissioners' Reserve Valuation Method (CRVM) reserve and at the unearned valuation cost of insurance ($½ c_X$).[12]

When the original AG 38 was adopted, many companies introduced designs that focused on step 4—the single premium to fully fund the shadow account for the remaining secondary guarantee period (or segment). One common approach was to develop an array of premium loads that may apply to a payment, or to portions of a payment, where the rates depend on the actual level of funding in each year. The loads were typically designed so that the single-premium funding requirements would be relatively high while level-premium funding patterns remained competitive. However, the 2005 amendment of AG 38 essentially eliminated the statutory reserve impact of these designs by introducing Section 8B, in which step 4 requires a standardized 7 percent premium load assumption.

Next, attention shifted to step 1—the minimum gross premium to satisfy the secondary guarantee. Many companies offered products where two alternative scales of cost of insurance rates or interest credits would apply to the shadow fund based on criteria defined in the contract. In the common "dual shadow account" design, for example, a premium is applied to the account with the more favorable rates as long as the shadow account is positive (*i.e.*, at least $0.01), and to the second account otherwise, with the less favorable charges being assessed as long as value remains in the second account. Whether dual account or not, these designs are such that a policyholder paying a level premium, and paying it always on time, would be eligible for the more favorable rates, while a policyholder who has fallen behind or is paying on a YRT type of pattern could be subject to the less favorable rates.

THE $0 TO $0 RULE

The language that has been primarily at issue in the most recent iteration of AG 38 relates to that last design and its treatment relative to Section 7A(4) of Regulation XXX. Section 7A(4) reads, in pertinent part: "the minimum premium for any policy year is the premium that, when paid into a policy with a zero account value at the beginning of the policy year, produces a zero account value at the end of the policy year" (herein referred to as "the $0 to $0 rule").[13] Generally, this was understood to mean that the minimum premiums to be used for purposes of valuation were an increasing scale based on the charges and credits for each year of coverage, rather than a level premium like the UL Model Regulation's guaranteed maturity premium.[14] Specifically, though, many companies followed this section literally, concluding that since a premium paid when the shadow account is exactly $0.00 would be subject to the less favorable rates in their product designs, then the minimum premiums defined by XXX in this circumstance are those needed to fund the less favorable scale of charges for each year. This interpretation results in higher minimum valuation premiums and, generally, lower reserves than would be obtained using the more favorable rates.[15]

Many companies offered products where two alternative scales of cost of insurance rates or interest credits would apply to the shadow fund based on criteria defined in the contract.

State regulators, through oral and published statements and ultimately through the 8D and 8E updates to AG 38, have made it clear that this was not the expected result. A statement drafted by LATF and formally adopted by them on Nov. 1, 2011, stated:

> The correct application of the requirements and Actuarial Guideline XXXVIII, Section 8, Step 1, for these product designs is to derive the "minimum gross premiums" that represent the *lowest* schedule of premiums a policyholder could pay to satisfy the secondary guarantee. For the product design described above, the lowest schedule of minimum gross premiums a policyholder could pay to reflect the benefits of the secondary guarantee is derived by applying the secondary guarantee with the lowest set of charges and/or highest crediting rates.[16]

TAX RESERVE CONSIDERATIONS

There are a number of interesting aspects to this situation as it relates to tax reserves. One of the most obvious is the

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complexity of the generational statutory guidance, which is of course critical to understand since IRC 807(d)(3) points to the NAIC-prescribed method in effect on the date of the issuance of the contract. The history of this statutory guidance is summarized in the "Calendar of AG 38 Applicability—Statutory Valuation" (shown below) along two dimensions: horizontally as a timeline by issue date of a ULSG contract, and vertically by the hierarchy of authority.

A comparison of the AG 38 adoption dates with the corresponding (statutory) issue date ranges on the Calendar illustrates that the previous updates had varying rules for statutory applicability. Steps 1 and 2 of the original Section 8 (now 8A), as well as Sections 1 through 7 of the guideline, were viewed by the NAIC in 2002 as clarifications to the existing model regulation so were applicable from the original effective date of XXX. The NAIC distinguished steps 3 through 9 of Section 8A as a new interpretation that would apply prospectively only, starting from Jan. 1, 2003. Similarly, Sections 8B and 8C each introduced new interpretations and new factors for certain assumptions, and they were applied prospectively starting from July 1, 2005, and Jan. 1, 2007, respectively.

The latest revisions and statements present a different situation, in which certain state regulators denied the specific application of the $0 to $0 rule in the context of products with multiple scales of charges or credits, arguing that the use of higher gross premiums is (and has been) inconsistent with the requirements of CRVM as already defined by XXX and inter-

CALENDAR OF AG 38 APPLICABILITY - STATUTORY VALUATION

APPLICABLE TO CONTRACTS ISSUED:

1/1/2000 ⟶ 1/1/2003 ⟶ 7/1/2005 ⟶ 1/1/2007 ⟶ 1/1/2013 ⟶ ??

Law:

Standard Valuation Law (Model 820)
-Section 5 defines commissioners' reserve valuation method (CRVM)
-Section 8 (1976) defines alternative minimum reserve (AMR), or deficiency reserves

(??: Life PBR)

Regulation:

Valuation of Life Insurance Policies Model Regulation (Reg. XXX, Model 830)
- Adopted Mar. 1999
- Section 7 describes basic and deficiency reserves for ULSG

Actuarial Guideline:

AG 38 Example 8A (steps 1-2 only)
- Adopted Sept. 2002
- Clarifies that shadow accounts do fall under XXX Section 7, using the minimum gross premiums as the "specified premiums" for basic and deficiency reserves

AG 38 Example 8A
- Adopted Sept. 2002
- Introduces an additional reserve based on any actual pre-funding of the secondary guarantee
- Defines denominator of funding ratio as the single premium needed to fund the remaining secondary guarantee, assuming minimum gross premiums have been paid through the valuation date
- Applies a cap at NSP using defined select factors (not X-factors)
- Allows total reserve to be reduced by applicable surrender charges
- Reduces XXX deficiency reserve by the funding ratio; generally reallocates that amount as basic reserve

For NAIC annual statements 2005-2011 (and 2012+ for 8D exclusions)

AG 38 Example 8B
- Adopted Oct. 2005
- Changes to a standard 7% premium load allowance for denominator of funding ratio

AG 38 Example 8C
- Adopted Sept. 2006
- Introduces lapse rates
- Requires stand-alone asset adequacy analysis
- Clarifies that ULSG reserves are still segmented as in XXX
- Accompanied by Model Reg. 815 introducing 2001 CSO preferred class structure mortality tables

For NAIC annual statements 2012+ (*with some exclusions; see note 20*)

AG 38 Example 8D
- Adopted Sept. 2012

a. Primary reserve methodology
- Starts with company's existing (year-end 2011) interpretation of 8B / 8C
- Adds excess if needed to hold at least the VM-20 deterministic reserve (with market-based investment earnings and discount rates)

b. Alternative reserve methodology
- Allows reserve based on LATF interpretation of 8B and 8C (with XXX deficiency reserve mortality/lapse based on VM-20 deterministic reserve)

c. Requires stand-alone Actuarial Memorandum, with copy to NAIC FAWG

AG 38 Example 8E
- Adopted Sept. 2012
- Defines minimum gross premiums explicitly based on the LATF interpretation; three safe harbor designs plus extensive guidance for considering alternative designs
- Limits the actual shadow account credits for the safe harbor designs, based on corporate bond index
- Develops rules for negative funding ratio
- Uses a reduced surrender charge related to remaining secondary guarantee period
- Requires specific Actuarial Opinion and Company Representation for all products offered in 2013+, with copy to NAIC FAWG

Other relevant guidance:

Revised XXX Practice Note (AAA)
- Adopted Dec. 2006
- Describes minimum premium "to carry the shadow account from one anniversary to the next"

LATF Statement on AG 38
- Adopted Nov. 2011
- Requires use of "*lowest* schedule of premiums a policyholder could pay to satisfy" the guarantee

Abbreviations:

AAA	American Academy of Actuaries
FAWG	Financial Analysis (E) Working Group
LATF	Life Actuarial (A) Task Force
NAIC	National Association of Insurance Commissioners
NSP	Net single premium
ULSG	Universal life insurance with secondary guarantees
VM-20	"Requirements for Principle-Based Reserves for Life Products," in NAIC valuation manual (adopted Aug. 17, 2012 or later), specifically Section 4: "Deterministic Reserve"

preted by AG 38.[17] AG 38, after all, included a specific "letter and spirit of the law" clause in its introduction.[18] Rather than conceding, as with the tiered premium load design discussed above, that companies were in fact using the prescribed method and that the prescription needed to change accordingly to eliminate a loophole, LATF asserted with respect to the determination of minimum gross premiums that "the requirements are clear and no changes or clarifications are needed to these requirements."[19]

In addition to the unambiguous opinions asserted in LATF's Nov. 1, 2011, statement, the final AG 38 framework in Sections 8D and 8E underscores the regulators' position that the use of multiple scales of charges and credits in order to reduce reserves was simply not consistent with the prescribed method. Section 8D, applicable for most in-force business subject to either 8B or 8C,[20] allows companies already following the LATF interpretation to continue with their current reserve approaches and levels. Companies not following the "correct" interpretation must hold an additional amount based on the PBR deterministic reserve, to the extent that it exceeds the reserve developed using their existing 2011 statutory method.

Section 8E, applicable for new business starting in 2013, explicitly requires that the minimum gross premium be based on "the set of charges and credits … that produces the lowest premiums." In painstaking detail that expanded step 1 from one sentence to well over a page of text (plus a page of new reporting requirements), Section 8E reiterates the LATF interpretation for the targeted design while also attempting to prevent future "aggressiveness" related to the minimum gross premium component of the reserve, even imposing limitations on the guaranteed policy credits that companies can offer.

One question this history raises is whether the federally prescribed reserve should be modified on in-force ULSG business to use the "correct" interpretation as put forth by LATF. Although the "$0 to $0" language was part of XXX, regulators contended that the particular designs and interpretations described above were inconsistent with the underlying principle of the regulation, which is that "similar reserves be established for policy designs that contain similar guarantees."[21] In other words, the existing method couldn't have been CRVM because it was *incorrect* in the regulators' eyes. Although many companies disagree with that version of the tale, it appears

that tax practitioners could develop arguments for a change in basis for the FPR so that the tax reserve method conforms to "the letter and spirit" of XXX through use of the lowest minimum gross premium, at least if the statutory basis were changed fully to that method as well.[22] The Internal Revenue Service (IRS) could well view such a change in basis as being subject to the 10-year spread under IRC Section 807(f).

A related question is whether an IRS challenge to such a conforming change would create a situation similar to TAM 200328006, which as various commentators have discussed in previous issues of *Taxing Times*, was one of the ruling positions that led to the *American Financial* case.[23] Peter Winslow wrote:

> 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.

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An important implication of this TAM was that if it had been upheld and the taxpayer had not been allowed to use AG 33 as its tax reserve method for contracts issued prior to the date AG 33 was adopted by the NAIC, then two companies that had essentially identical products issued in the same years would be subject to two different tax reserve requirements.

This anomaly can arise in the current instance as well. Assume that for a shadow account product sold in 2008, Company A already held reserves based on the lower minimum gross premiums prior to adoption of the revised AG 38, while Company B used the higher premiums. If Company B were to change its statutory reserves fully to the "correct" interpretation of XXX as maintained by LATF (following the "Alternative Reserve Methodology" of AG 38 Section 8D.b), and if the IRS were to refuse a corresponding change to the FPR for Company B, then Company A and Company B would have essentially identical products but two very different levels of FPRs.

To complicate the situation, assume Company C previously used the higher minimum gross premiums but elects instead to switch to the compromise "Primary Reserve Methodology" of AG 38 Section 8D.a for its affected in-force business. As described above, under this compromise, companies maintain their existing statutory method from 2011 as a baseline and add an amount based on the deterministic reserve defined in VM-20—*i.e.*, a component of PBR. Clearly the addition of a PBR deterministic reserve was not part of CRVM on the date of issuance of the contract, so that would be difficult to support as a viable tax reserve method for Company C. But since the existing statutory reserving approach was not consistent with the NAIC interpretation (the "spirit of the law" wording in the AG 38 introduction), it also seems inappropriate to consider the old approach to be CRVM for tax reserve purposes.

Regardless of the position a company takes on the tax reserve method for the FPR, a good argument exists that any increase to a policy's statutory reserve as a result of the VM-20 deterministic reserve excess according to AG 38 Section 8D.a.2 should be considered part of the statutory cap for that policy, as has been argued for the CTE amount in AG 43.[24]

WHAT'S NEXT FOR AG 38?

During the preparation of this edition of *Taxing Times*, on Oct. 29, 2012, the NAIC formed a new working group "to provide timely actuarial guidance for companies seeking to comply with the revisions to Actuarial Guideline 38 (AG 38) with respect to both in-force and prospective business."[25] The working group, which will report to the NAIC's Financial Condition (E) Committee, is charged with considering questions submitted to it by state regulators and companies and releasing guidance after an abbreviated public review and comment period. The guidance is intended to be binding for purposes of FAWG review, thus imposing another layer of guidance on the already complex ULSG landscape.

In other work, the NAIC has been exploring the use of captive insurance companies and other special purpose vehicles, which have been used by many companies to improve their positions related to capital-intensive products under XXX and AG 38. To the extent the allowed or viable structures change as a result of this work, companies will also need to consider tax consequences of their financing decisions.[26]

Additionally, as indicated at the right side of the Calendar, AG 38 is intended to be replaced for statutory purposes by PBR when it is adopted. The latest installment of the actuary/tax attorney dialogue in this issue explores the current status of that major initiative. PBR is in many respects the ultimate "spirit of the law" approach to the valuation of XXX reserves, so it will be interesting to see what may arise as the X-rated saga continues. ◂

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

The author wishes to thank Edward Robbins and Keith Bucich for their input on a draft of this article. The opinions expressed are those of the author.

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

END NOTES

[1] For an enlightening discussion of the controversies and other background of AG 38, see Christian DesRochers, "X-Rated Reserves: AXXX and XXX," *Taxing Times*, Vol. 4, Issue 1 (February 2008).

[2] AG 38, Introduction. Regulation XXX is Model 830 under codification. XXX in turn supports the Standard Valuation Law (SVL), which is Model 820.

[3] AG 38, Introduction.

[4] "NAIC statement regarding adoption of RMORSA Model Act and revisions to AG 38," Sept. 12, 2012, at *http://www.naic.org/Releases/2012_docs/naic_statement_adoption_rmorsa_model_act_ag38.htm*, accessed Nov. 4, 2012. The revised guideline may be found at *http://www.naic.org/documents/committees_jt_ae_ag38_prop_revisions_adopted_a_e_120906.pdf*, accessed Nov. 4, 2012.

[5] PBR is not yet in effect for life insurance products, but the relevant AG 38 component is subject to the deterministic reserve requirements in VM-20 of the Valuation Manual that was adopted by the Life Insurance and Annuities (A) Committee on Aug. 17, 2012 (AG 38, Section 8D.a.2). See also American Academy of Actuaries, Life Insurance Issues: Alert No. 2012-L-8, "NAIC's Life Insurance Committee Adopts Valuation Manual," Aug. 17, 2012.

[6] IRC Section 807(d)(3)(B)(i). All code references are to the Internal Revenue Code of 1986, as amended.

[7] XXX Section 7A(1)(a).

[8] XXX Section 7A(1)(b).

[9] AG 38, Effective Date.

[10] This is necessarily an abbreviated description to explain the general concepts underlying the Example 8 approach. See AG 38 for the full description of the method and its variations under 8A through 8E. This presentation of the "corridor" concept in steps 6 and 8 is similar to that provided by Edward Robbins and Richard Bush in *U.S. Tax Reserves for Life Insurers* (Society of Actuaries 2006) at 284.

[11] AG 38 Section 8E introduces new methods for handling a negative funding ratio.

[12] XXX Section 7D(2).

[13] XXX Section 7A(4).

[14] Question and answer 53 of the American Academy of Actuaries XXX Practice Note (December 2006 update) states: "The minimum premiums are typically calculated for each policy year. For a shadow account design this would be the minimum premium required to carry the shadow account from one anniversary to the next."

[15] It is actually the *slope* rather than the absolute level of charges that determines the level of reserves. Therefore, it is possible that the reverse is true: that the use of the less favorable rates may have produced a *higher* XXX_{7B} reserve at a particular date. (See SVL Section 5A, which defines the modified net premium to be equal to a uniform percentage of gross premiums.)

[16] Life Actuarial (A) Task Force: Statement on Actuarial Guideline XXXVIII, *http://www.naic.org/documents/committees_e_emerging_actuarial_issues_wg_related_ag38_final.pdf*, accessed Dec. 11, 2012; emphasis in original. The ACLI vehemently opposed an earlier exposure draft in an Oct. 19, 2011, comment letter, but LATF adopted the statement essentially as exposed. For more on these exchanges and on varying positions surrounding the treatment and relevance of the $0 to $0 rule, see Keith Bucich, "AG38 Update," *THE FINANCIAL REPORTER* Issue 89 (June 2012) at 14.

[17] LATF Statement, *supra* note 16. "[Reserves that use the higher scale of minimum premiums] do not properly reflect the full benefits of the secondary guarantee as required by the law, regulation and guideline."

[18] AG 38 goes on to state: "Policy designs which are created to simply disguise those guarantees or exploit a perceived loophole must be reserved in a manner similar to more typical designs with similar guarantees" (AG 38 Introduction, which had no substantive changes in the recent round of revisions).

[19] LATF Statement, *supra* note 16. LATF did, however, proceed with clarification of the requirements, working out the various elaborations and safeguards now contained in Sections 8D and 8E.

[20] That is, ULSG policies subject to XXX that were issued July 1, 2005, through Dec. 31, 2012, and which contain multiple sets of charges and credits related to secondary guarantees. Section 8D also exempts:
- Policies for which reserves already use the lowest minimum guaranteed premiums,
- Companies whose relevant ULSG blocks do not meet certain materiality thresholds, and
- Companies that file for and receive an exemption from the domiciliary regulator and FAWG.

[21] AG 38, flush language preceding Section 1.

[22] The FPR would still need to exclude deficiency reserves and be adjusted to reflect the appropriate tax-basis mortality table and interest rates.

[23] See Peter Winslow, "The Sixth Circuit Gets It Right in *American Financial*—An Actuarial Guideline Can Apply to Prior Contracts When the Interpretation Was a Permissible Option at the Time the Contract Was Issued," *Taxing Times* Vol. 8, Issue 3 (FEBRUARY 2013) at 7, and Richard N. Bush, "IRS Rules on *American Financial*," *Taxing Times* Vol. 6, Issue 3 (September 2010) at 10.

[24] See, for example, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principle-Based Reserves (Part IV)" in this issue of *Taxing Times* at 50.

[25] American Academy of Actuaries, Life Insurance Issues: Alert No. 2012-L-11, "NAIC Creates Working Group to Provide Guidance on Actuarial Guideline 38," Nov. 1, 2012.

[26] For additional perspective on the types of tax considerations involved in XXX financing, see Seth L. Rosen and Arthur C. Schneider, "XXX Reserve Funding is Debt for Federal Tax Purposes," *TAXING TIMES* Vol. 5, Issue 3 (September 2009).

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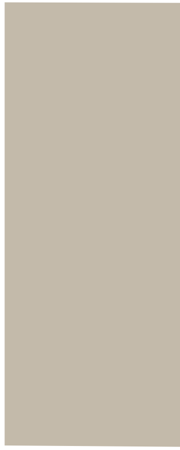
THE PERILS OF REDUCING DEATH BENEFITS: PRIVATE LETTER RULING 201230009

By John T. Adney and Craig R. Springfield



In PLR 201230009 (Jan. 30, 2012), the Internal Revenue Service (the "Service") ruled that a reduction in death benefit accomplished by a contractual modification would cause a life insurance contract to be treated as "newly issued" for purposes of § 5 of Notice 2006-95[1] (the "Notice"), which relates to certain safe harbors for satisfying the reasonable mortality charge requirements of section 7702(c)(3)(B)(i).[2] Consequently, if this private letter ruling is correct, it would no longer be permissible to use the 1980 Commissioners' Standard Ordinary ("CSO") mortality tables for purposes of the calculations under section 7702 following such a death benefit reduction.

FACTS

The life insurance contracts involved in PLR 201230009 complied with section 7702, the federal tax definition of "life insurance contract," by satisfying the cash value accumulation test of section 7702(b), and the computations required by section 7702 were performed using the 1980 CSO mortality tables. The ruling states that owners of the contracts in some circumstances want to decrease their death benefits and that the decreases contemplated are not ones resulting from application of a formula or other provision set forth in the contracts. Rather, the decreases would be accomplished by modifications to the existing contracts, since the contracts do not provide owners with a contractual right to decrease their death benefits.[3] The ruling also lists various non-tax-related reasons why an owner might want to decrease the contract's death benefit, *e.g.*, if the owner no longer needs the full amount of the original coverage, market downturns under a variable contract which increase the net amount at risk and cost of the contract, or the owner's inability to afford the original premiums.

TAXPAYER'S USE OF NOTICE 2006-95 SAFE HARBORS

The issuer of the contracts (*i.e.*, the taxpayer in the ruling) represented that the contracts qualified under the safe harbors in Notice 88-128[4] and Notice 2006-95 that deem mortality charges based on the 1980 CSO mortality tables to be "reasonable" mortality charges for purposes of the reasonable mortality charge requirement of section 7702(c)(3)(B)(i). This statutory provision requires use of "reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued."[5] Notice 2006-95 provides safe harbors for satisfying section 7702(c)(3)(B)(i) in the case of 1980 CSO contracts, but limits the scope of those safe harbors to contracts "issued"[6] before Jan. 1, 2009.

MATERIAL CHANGE RULES APPLICABLE TO SAFE HARBORS

Notice 2006-95 includes special rules for determining whether a change will cause a contract to be treated as newly "issued" for purposes of applying the Notice. In particular, § 5.01 of the Notice establishes a general material change rule, stating that "the date on which a contract was issued generally is to be determined according to the standards that applied for purposes of the original effective date of § 7702." This § 5.01 standard more or less tracks statements in the legislative history of the effective date of section 7702, which generally treats changes in the material terms and benefits of a contract as resulting in a deemed exchange (and thus new "issuance" of a contract) if the change is not pursuant to a contractual right.[7] Also, § 5.02 of Notice 2006-95 provides an alternative rule for avoiding new "issue" treatment, stating that:

> "[I]f a life insurance contract satisfies [one of the Notice's safe harbors for use of 1980 CSO] when originally issued, a change from previous tables to the 2001 CSO tables is not required if (1) the change, modification, or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank."

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In PLR 201230009, the taxpayer represented that it would grant an owner's request for a decrease in death benefit only if the second and third of the above Notice § 5.02 requirements were met. Thus, the subject of the ruling was whether the first of the above requirements was met. In particular, the question posed was whether new "issue" treatment of the contract could be avoided for purposes of applying the Notice even though the proposed decreases in death benefits would be accomplished through contractual modifications, requiring the insurance company's consent, rather than pursuant to any contractual rights possessed by owners of the contracts.

THE SERVICE'S ANALYSIS

In its analysis of the issue, the Service focused on the fact that the proposed change would not occur as a result of the exercise of a contractual right, and because of this characteristic of the transaction, the Service concluded that the change was not "pursuant to the terms of the contract" within the meaning of § 5.02 of Notice 2006-95. The Service recognized that some life insurance contracts include contractual rights to reduce the amount of coverage, but commented that the proposed death benefit decreases under the contracts "neither occur[] automatically upon the satisfaction of a condition set forth in the Contracts nor as a result of the exercise of any contractual right provided to a party to the contract." Based on these considerations, the Service ruled that: "A reduction in the face amount under a Contract, pursuant to the owner's request and with [the insurance company's] consent, results in an exchange that causes the Contract to be treated as newly issued for purposes of reasonable mortality charge requirements of § 7702(c)(3)(B)(i)."[8]

COMMENTARY

The Service's position in PLR 201230009 has generated significant concern within the life insurance industry, in part because it may force insurers to prohibit decreases in death benefits where policyholders do not possess a contractual right to make the change (even if the insurer has commonly permitted such transactions in the past) and also due to difficulties that would arise if the rationale that seems to underlie the Service's position were applied more broadly.[9] The rationale of the ruling also portends possible difficulties for the future: for example, insurers today may commonly permit certain extra-contractual changes to 2001 CSO contracts since "new issue" treatment would not affect the applicable mortality table under the reasonable mortality charge rule; however, those insurers might have to stop those practices when and if a new mortality table becomes prevailing.[10] And of course they likely then will need to explain to policyholders why the tax law imposes this restriction, even though no intervening change in the tax law has occurred and the new mortality table does not apply to the contract under state law. This is perhaps an apt point to remind the reader that a private letter ruling is directed only to the taxpayer who requested it, and a ruling cannot be used or cited (by the government or any other taxpayer) as precedent.[11] Of course, the issue addressed will often affect whether a contract complies with section 7702, and thus the Service's current position as reflected in the ruling cannot be ignored. The question nevertheless remains whether the ruling is correct, and what arguments and considerations are pertinent to this question.

POLICY CONSIDERATIONS RELATING TO USE OF THE DEFRA LEGISLATIVE HISTORY'S MATERIAL CHANGE STANDARD

An examination of the origin of the material change rules of § 5 of Notice 2006-95 is helpful in considering this question. In particular, the Service's initial guidance on how contract changes affect application of the reasonable mortality charge rule was contained in Notice 88-128, which was issued in the immediate aftermath of Congress' enactment of the reasonable mortality charge rule as part of TAMRA. Notice 88-128's material change rule is mirrored in § 5.01 of Notice 2006-95, in that they both define material changes by cross-referencing the material change standard contained in the DEFRA legislative history for the effective date of section 7702. We think it is pertinent to keep in mind that, at the time of Notice 88-128's issuance, Congress had just enacted the reasonable mortality charge rule to prevent taxpayers from over-stating guaranteed mortality charges (in some cases to many multiples of the prevailing CSO tables for standard risks) for the purpose of increasing the investment orientation of contracts under section 7702.[12] Also, 1980 CSO became the prevailing commissioners' table in 1984 and thus, taking into account the three-year transition rule of section 807(d)(5), use of 1980 CSO rather than 1958 CSO became mandatory under the then newly enacted reasonable mortality charge rule of section 7702(c)(3)(B)(i) for contracts issued on or after Oct. 21, 1988 (the effective date of the legislation).[13] Since this effective date did not correspond with state law transitions to 1980 CSO, the Service provided effective date relief in Notice 88-128 for 1958 CSO contracts if certain requirements were met in the case of contracts "issued" on or before Dec. 31, 1988. This relief was needed immediately upon TAMRA's enactment in

order not to disrupt sales of contracts. This timing problem in part accounts for the industry's request for and the Service's provision of the guidance only a month after passage of the legislation. At the same time, Notice 88-128 was intended to be temporary measure, since section 5011(c)(1) of TAMRA had directed the Secretary of the Treasury to issue regulations interpreting the reasonable mortality charge requirements by Jan. 1, 1990.[14] Against this backdrop, it is not surprising that the Service applied a stringent material change standard in order to limit the relief provided by the Notice.

While the policy rationale for applying a stringent material change rule as a temporary measure under quick turnaround guidance is understandable, there is far less justification for imposing such treatment as a permanent rule. Changes in mortality tables are unlikely to be the principal (or even a material) motivation underlying a policyholder's request for a change in the terms or benefits of his or her contract. Also, changes in mortality tables are incremental in nature, reflect changing characteristics of the population at large, and may involve either improving or worsening mortality. Further, new mortality tables do not reflect a new Congressional enactment (with a new rule to apply to newly issued contracts and with a grandfather rule to protect existing contractual relationships); rather, changes in the prevailing mortality table occur as a result of action by the National Association of Insurance Commissioners and the states to reflect changes in the population's mortality and state regulation of insurance.

Also, and perhaps more importantly, it is somewhat far-fetched to say that policyholders are motivated to alter their insurance coverage due to a change in the prevailing mortality table, and this seems doubly true where coverage is being decreased. Instead, what they care about is whether they will be able to make a change that they might desire for non-tax-motivated reasons, and in this regard PLR 201230009, if it is correct, presents a substantial obstacle. For example, for a 1980 CSO contract purchased in the mid-1980s, the insurer may have routinely permitted certain changes that are not made pursuant to contractual rights (but which may reflect the insurer's usual business practices) and may have continued to do so after 2008. Under the Service's rationale in the PLR, however, the insurer seemingly would no longer be allowed to pursue such practices, even though no tax motivation would be associated with a change.

RELATIONSHIP BETWEEN NOTICE § 5 AND THE ADJUSTMENT RULE OF SECTION 7702(f)(7)(A)

Despite the above considerations, DEFRA's material change standards were incorporated into later guidance—*i.e.*, Notice 2004-61 and Notice 2006-95—regarding the transition from one mortality table to the next. Notice 2006-95's safe harbors provided welcome clarification that many types of routine changes pursuant to the terms of a contract would not result in a deemed new issuance of a contract, which was of some concern given Notice 88-128's use of the DEFRA material change standards and ambiguities regarding the manner in which those standards should apply. At the same time, the retention of the underlying structure based on DEFRA's material change standards was both unnecessary and problematic. Congress adopted a specific statutory rule as part of section 7702—*i.e.*, the adjustment rule of section 7702(f)(7)(A)—to address changes in the terms and benefits of contracts, and there is no reason to believe Congress intended for that rule to apply only to changes requested by the policyholder pursuant to a contractual right.[15] Such a limited application of the adjustment rule seems, however, to underlie the Service's application of Notice 2006-95.

Such a limited application of the adjustment rule seems, however, to underlie the Service's application of Notice 2006-95.

To highlight the conflict with the adjustment rule, it is informative to consider the proper treatment of changes under a life insurance contract that are not made pursuant to the terms of a contract where no change of prevailing mortality tables is involved. For example, if a 1980 CSO contract was issued in 1989 and then such a change (*e.g.*, a reduction in death benefit not pursuant to a contractual right) was made in 2006, should "new issue" treatment have been accorded to the contract so that wholly new guideline premiums based on the insured's attained age in 2006 should apply? We think it would be very difficult to support such a view, since the adjustment rule of section 7702(f)(7)(A) is the specific statutory rule that Congress adopted to address the effect of such a change[16] and because section 7702's legislative history prescribes use of the so-called attained-age decrement method as the "proper adjustment" for death benefit decreases under this rule.[17]

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If this is correct, then should a different treatment apply to contracts if there happens to be a change in the prevailing mortality tables? On what basis would "new issue" treatment apply rather than the statutorily required application of the adjustment rule, apart from the fact that most insurers currently strive to comply with the safe harbors of Notice 2006-95 and thus they conform their practices to the requirements of those safe harbors? It would be odd—and probably unworkable—to conclude that a contract has one "issue date" generally under section 7702 but a different one for purposes of interpreting this term as used in section 7702(c)(3)(B)(i). Ultimately, we think a contract should be viewed as having a single "issue date" for purposes of section 7702, including as this term is used in section 7702(c)(3)(B)(i).

Many insurers have avoided the conflict between the adjustment rule and the DEFRA legislative history's material change standard as incorporated into Notice 2006-95 by ceasing to permit changes that are not pursuant to contractual rights, thus rendering the conflict moot. In our view, this was a result Congress never intended—rather, we think Congress contemplated that all changes would be accounted for under the adjustment rule and, necessarily, this means that such changes would not result in "new issue" treatment under the statute, since in that event the adjustment rule would not apply. The propagation of the DEFRA legislative history's material change standard in Notices after Notice 88-128 explains how this conundrum arose. At the same time, we think the rules can be reconciled in a manner that protects the interests of the fisc while also allowing non-tax-motivated transactions under life insurance contracts that can be, and in our view were intended to be, addressed by the adjustment rule.

ADDITIONAL RATIONALE FOR PERMITTING DECREASES IN BENEFITS

While application of "new issue" treatment and the adjustment rule are mutually exclusive, the practical tension between these two treatments in connection with the reasonable mortality charge rule would be substantially ameliorated by clarifying that the adjustment rule takes precedence for purposes of applying Notice 2006-95 in circumstances where the change does not involve utilization of the prior table to increase a contract's investment orientation. In the case of a decrease in death benefit (*i.e.*, where the pre-change death benefit and other contract values are already based on the prior table), there is no such utilization and, thus, there is no policy reason for applying any treatment other than the statutorily prescribed adjustment rule. Thus, we think § 5 could be construed reasonably such that decreases in death benefits are governed by the adjustment rule of section 7702(f)(7)(A) and that the DEFRA legislative history does not operate to require "new issue" treatment in this circumstance.

The DEFRA legislative history supports this conclusion. In particular, section 7702 as originally enacted included a special rule treating benefit reductions as exchanges for a limited purpose (so that distributions would be taxable under the boot rule of section 1031(b)), but the DEFRA legislative history clarifies that such exchange treatment does not apply for purposes of the effective date rule for section 7702. Specifically, the DEFRA Bluebook states: "The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts ...; Thus, section 7702 will not become applicable to a contract that was issued before January 1, 1985, because a reduction of the contracts [sic] future benefits resulted in the application of this adjustment provision."[18] This legislative history confirms that Congress did not contemplate that reductions in benefits would result in a newly "issued" contract. In the context of PLR 201230009, it thus seems that the Service could have reached a favorable result based on

§ 5.01 of Notice 2006-95, since it follows the DEFRA legislative history's material change standard, including this discussion of benefit reductions.[19]

LIMITED OPTIONS FOR INSURER SELF-HELP

For many life insurance contracts, the precise issue presented in PLR 201230009 is inapplicable since the contracts include express rights to decrease the amount of coverage. For contracts like the ones involved in the ruling, however, a further question is whether there is an opportunity to avoid the problem, such as by engaging in a section 1035 exchange for a smaller 2001 CSO life insurance contract. In some cases, this avenue may be available, but in others a number of obstacles may preclude this possibility, especially for ordinary whole life insurance. For example, if the original and new whole life contracts have fixed periodic premiums, the new contract's premiums may be based on the insured's higher attained age, and thus the desired premium reduction may not be available to the extent the policyholder might desire. Also, the existing contract's cash value will need to be applied to the new contract, which may only be possible if the new contract permits "dump-ins" of premiums beyond the otherwise applicable fixed premiums, *e.g.*, through a paid-up additions rider. In addition, for all types of contracts, cash value may need to be distributed in connection with the exchange in amounts significantly greater than would have applied if the reduction could have been made to the existing contract. Such distributions may be subject to surrender charges and taxable as "boot." The new contract also may provide for surrender charges, expressly or implicitly, and the insurer may not even offer a comparable form anymore that is acceptable to the policyholder. Finally, since there would often be an increase in net amount at risk, the insurer may need to insist on re-underwriting the insured as a condition to allowing the exchange. For these and other reasons, use of an exchange to accomplish a decrease in death benefit is at best cumbersome.

Other avenues for self-help can be undertaken for newly issued contracts with an eye toward future changes in the prevailing mortality tables. In particular, insurers should strive to incorporate into their contracts express terms to govern all of the types of contract modifications they can reasonably foresee. This may be an attractive solution for many insurers. For existing 1980 CSO and older contracts, however, no such self-help is possible, and it thus appears that an insurer's only recourse if it wants to permit changes that are not pursuant to contractual rights is to forgo the protection of Notice 2006-95's safe harbors. Such a step should not be taken lightly, however, since the application of the reasonable mortality charge rule without regard to the Notices is unclear and, at least in some cases, use of the safe harbors is the only way to comply with the statute.[20]

FINAL THOUGHTS

While private letter rulings are not precedential, insurers naturally are very concerned about the stance of the Service in PLR 201230009 and also about the potential that the rationale that seems to underlie the PLR would be more broadly applied. The ruling appears to offer homage to general material change principles under the tax law while ignoring the fact that Congress has prescribed a specific approach for addressing contract changes through enactment of the adjustment rule. Also, the ruling applies an overly rigid interpretation of § 5 of Notice 2006-95 which appears to disregard the policy consideration involved in the transition from one prevailing table to the next. We believe that the Service appreciates the policy arguments in favor of allowing decreases in benefits, but felt compelled to rule as it did in order to follow what it took to be the literal requirements of Notice 2006-95. Hopefully, the Service will modify its position on the PLR and, in all events, there is good reason to revisit (and either dispose of or substantially limit) the use of the DEFRA legislative history's material change standard once future published guidance on transition to new prevailing mortality tables is issued.[21] In the meantime, insurers will need to grapple with the conundrum presented by PLR 201230009. ◂

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END NOTES

1. 2006-2 C.B. 848.
2. Except as otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended.
3. The ruling states that the "Contracts do not include a provision that explicitly contemplates the owner's ability to request a decrease in coverage under the contract" and that the "Contracts do not contain any terms that operate to alter … the amount of coverage." The ruling also states that the decrease in death benefit "neither occurs automatically upon the satisfaction of a condition set forth in the Contracts nor as a result of the exercise of any contractual right provided to a party to the contract." From these statements, and especially the last one, it appears that the policyholders had no contractual right to decrease death benefits, either pursuant to an explicit provision in the contracts or otherwise under state law.

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END NOTES CONT.

[4] 1988-2 C.B. 540.

[5] The reasonable mortality charge rule also can be satisfied by meeting an interim rule set forth in § 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 ("TAMRA"), which treats mortality charges as meeting the requirements of section 7702(c)(3)(B)(i) where such charges "do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)."

[6] The "Bluebook" covering the enactment of section 7702 explains that "… the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed." STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 655 (Comm. Prt. 1984) ("DEFRA Bluebook").

[7] *See* S. Prt. No. 98-169, VOL. I, at 579 (1984) (the "DEFRA Senate Report"); DEFRA Bluebook, at 656.

[8] The ruling earlier stated that: "Taxpayer requests a ruling that a reduction in the face amount under a Contract pursuant to the owner's request and with Taxpayer's consent, will not cause the Contract to be treated as 'newly issued' for purposes of § 5 of Notice 2006-95." In view of phrasing of the taxpayer's request, it is unclear why the ruling speaks in terms of the effect of the change under the statute rather than under the Notice. The Notice principally provides safe harbors for satisfying the reasonable mortality charge rule rather than comprehensive guidance on the rule, and on its face, § 5 of the Notice applies only for purposes of the Notice.

[9] It usually will not be feasible to allow a change if the consequence is application of a new mortality table under section 7702. For example, in the case of fixed premium contracts with mortality guarantees based on 1980 CSO, minimum nonforfeiture values generally would exceed those permissible under the cash value accumulation test if that test has to be applied using 2001 CSO.

[10] Notice 2006-95 does not address the transition that eventually may be needed to a post-2001 CSO table, and thus one can anticipate that further published guidance from the Service will be needed to clarify how such a transition applies.

[11] *See* section 6110(k)(3).

[12] The TAMRA House Report explains Congress' motivation as follows: "Concerns have been raised that some insurance companies are taking aggressive positions with respect to mortality and expense charges. Specifically, companies may be overstating mortality and expense charges and then rebating them to policyholders, or not charging the stated amounts. By overstating mortality and expense charges, insurance companies can increase the investment orientation of life insurance products, contrary to the intent of Congress when the definition of life insurance was enacted." H.R. Rep. 100-795, at 545 (1988).

[13] TAMRA section 5011(a).

[14] The Service and Treasury Department issued proposed regulations on reasonable mortality charges in 1991, but no final regulations have ever been issued. *See* 56 Fed. Reg. 30718 (July 5, 1991). Interestingly, those proposed regulations did not include any material change rule that would deem a contract to be newly "issued" (nor was there any request for comments in this regard).

[15] In discussing circumstances where the adjustment rule would apply, the DEFRA Senate Report (at p. 577) states: "Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time." Also, for purposes of applying this rule to the calculation of guideline premiums, that Report (also on p. 577) notes that "no adjustment shall be made if the change occurs automatically due, for example, to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or due to changes initiated by the company." There is no indication in the legislative history that changes requested by the policyholder that are not made pursuant to a contractual right were excluded from the scope of the adjustment rule.

[16] A tenet of statutory construction is that more specific statutory rules govern over more general rules. *See*, *e.g.*, Fourco Glass Co. v. Transmirra Products Corp., 353 U.S. 222, 228 (1957) (citations omitted) ("However inclusive may be the general language of a statute, it will not be held to apply to a matter specifically dealt with in another part of the same enactment."); CRS Report for Congress: Statutory Interpretation: General Principles and Recent Trends, at CRS-10 (March 30, 2006).

[17] On its face, the DEFRA legislative history's discussion of material changes applies only for the purpose of determining whether a contract issued prior to 1985 becomes subject to section 7702 by reason of a material change in the contract's terms or benefits that is not made pursuant to an option in the pre-DEFRA contract. Thus, apart from the Service's adoption of those DEFRA standards for purposes of the reasonable mortality safe harbors, such standards have no application to a contract that is already subject to section 7702. (Our commentary herein assumes that a change does not cause a contract to be viewed as new under state insurance and contract law.)

[18] DEFRA Bluebook, at 654.

[19] While not directly applicable, we note that final regulations issued with respect to the Jan. 1, 1997 effective date of section 7702B, which defines "qualified long-term care insurance contract," provided that reductions in coverage (with corresponding reductions in premiums) made at the request of the policyholder would not result in "new issue" treatment for purposes of the effective date. We recognize that the Service distinguished the material change rules for this effective date from those applicable for life insurance due to differences in the investment orientation of such contracts. However, in the case of transactions such as reductions in death benefits that are undertaken without a tax motivation, seemingly the same policy conclusion that the Service and Treasury Department reached in those final regulations should apply in the life insurance context as well. We note that application of the adjustment rule will automatically require a return of funding under heavily funded contracts, which serves a purpose comparable to the reduction in premium requirement of the section 7702B regulations.

[20] On this latter point, we note that section 7702(c)(3)(B)(i) requires use of mortality charges not exceeding ones based on the 2001 CSO tables in the case of contracts issued after Dec. 31, 2007, but that Notice 2006-95 permitted continued use of 1980 CSO for contracts issued during 2008. It appears that this extension of the ability to use 1980 CSO only applies if the contract is not treated as newly issued under § 5 of the Notice.

[21] Notice 2006-96 does not purport to address the transition from 2001 CSO to any future prevailing mortality table.

IRS UTILIZES THE INDUSTRY ISSUE RESOLUTION PROGRAM TO RESOLVE THE INSURANCE INDUSTRY BAD DEBT ISSUE

By Arthur C. Schneider and Samuel A. Mitchell

The Internal Revenue Service ("IRS") is getting serious about resolving resource-intensive examination issues with taxpayers in specific industries through its Industry Issue Resolution Program (IIR Program) described in Revenue Procedure 2003-36.[1] Over the last several years, the IRS has utilized the IIR Program to resolve a number of industry-specific issues with taxpayers. Recent IIR resolutions have included repair and capitalization issues in the power generation and transmission and wireless telecommunications industries, and inventory issues in retail industries.[2] One of the latest successful IIRs disposes of a significant insurance industry issue. On July 30, 2012, the Large Business and International ("LB&I") Division of the IRS published a Commissioner's Directive memorandum to LB&I examiners outlining a safe harbor approach under which insurance companies may report bad debt deductions under Internal Revenue Code ("I.R.C.") § 166 to reflect the partial worthlessness of eligible loan-backed and structured securities that are subject to Statement of Statutory Accounting Principles 43R.[3] This article provides a top-level explanation of the bad debt IIR process and what the safe harbor guidance provides. The authors were part of the team that participated in the IIR process on behalf of the insurance industry.

THE INSURANCE INDUSTRY BAD DEBT ISSUE

In 2008 and 2009, insurance companies reported large investment losses as a result of the financial crisis. Many life and property-casualty insurance companies had invested heavily in residential mortgage-backed securities ("RMBS"), commercial mortgage-backed securities ("CMBS") and direct mortgages. For example, the American Council of Life Insurers ("ACLI") reported that as of Dec. 31, 2008, life insurance companies held in their general accounts approximately $530 billion in agency and non-agency mortgage-backed securities ("MBS") and $338 billion more in farm, residential and commercial mortgages.[4] As the crisis unfolded, insurance companies suffered significant credit losses as these structured instruments and mortgages became worthless in whole or in part. The National Association of Insurance Commissioners ("NAIC") has reported that in the years 2008 through 2010, insurance companies reported $26.8 billion in Other-Than-Temporary-Impairments ("OTTIs") and valuation adjustments in non-agency RMBS alone. Most of these RMBS losses occurred in 2008 ($9.2 billion) and 2009 ($14.7 billion).[5] Additional significant losses occurred in CMBS and mortgages.

The financial crisis resulted in significant tax reporting issues for insurance companies concerning partial worthlessness deductions. Throughout the early to mid-2000s, many insurance companies reported partial worthlessness deductions under I.R.C. § 166 consistent with their statutory OTTIs on RMBS, CMBS, mortgages and other instruments that are eligible for partial worthlessness deductions. To be eligible for a partial worthlessness deduction, the instrument must be a debt and must not be a security as defined in I.R.C. § 165(g)(2) (*i.e.*, the instrument must be a non-security).[6] The definition of a security under § 165(g)(2) includes debts with interest coupons or in registered form that are issued by a corporation, government or political subdivision thereof. Under this test, eligible non-security debts include many MBS and direct mortgages. While the treatment of these partial bad debts had been an examination issue in IRS audits of insurance companies for most of the preceding decade, the 2008 financial crisis increased the stakes exponentially. As it unfolded, the most significant tax deductions involved regular interests in Real Estate Mortgage Investment Conduits ("REMIC regular interests"), which encompass both RMBS and CMBS investments. A specific code provision (I.R.C. § 860B) mandates that REMIC regular interests are treated as debts for all federal tax purposes for the holder. Additionally, REMIC regular interests are issued by trusts (not corporations, governments or political subdivisions) and therefore are not securities under I.R.C. § 165(g)(2).

The REMIC regular interest partial worthlessness deductions that insurance companies reported on their 2008 and 2009 tax returns resulted in the most resource-intensive examination issue in the insurance industry in recent memory. As described in an earlier *Taxing Times* article,[7] LB&I examiners accepted that REMIC regular interests are eligible debts and that some deductions are appropriate. However, the examination teams

for the most part limited the allowance of the deductions to amounts that had been reported as property liquidations on REMIC trust remittance statements. This set up a timing issue because the OTTIs on which the companies based their deductions generally were consistent with statutory accounting requirements that reflected an assessment of the economic loss that had occurred. The structured debt instruments are long-term instruments that pay out in a cash-waterfall structure and are tied to underlying mortgages that can have terms of up to 30 years, often resulting in a significant time-lag between the time an OTTI is reported and the time the underlying mortgaged property is liquidated. Additionally, the OTTIs often are recorded while holders are still receiving payments under the cash-waterfall structure.

In many cases, the companies asserted that the OTTIs, which were required by statutory accounting rules to be charged off, were deductible based on the conclusive presumption of worthlessness in Treas. Reg. § 1.166-2(d)(1), which applies to "banks and other regulated corporations." Under the conclusive presumption, charged-off amounts are conclusively presumed to be worthless for tax purposes if the bank or other regulated corporation is required by its regulator to charge off the amount, or, in the alternative, if the regulator confirms in writing that the amount would have been required to be charged off if examined.

Many examiners accepted the application of the conclusive presumption to insurance companies, but nevertheless asserted that the deductions should be disallowed for other factual or legal reasons. For example, some LB&I examiners asserted that the deductions even under the conclusive presumption could not be allowed while the investors were still receiving payments. Taxpayers explained that the amounts written off were in fact worthless and not recoverable regardless of current cash flow under the cash-waterfall structure. Additionally, LB&I examiners asserted, based on Revenue Ruling 84-95,[8] that the deductions were fair value write-downs that are not subject to the conclusive presumption because they were not based on credit criteria. In Rev. Rul. 84-95, the IRS held that a bank could not rely on the conclusive presumption to support deductions based on mechanical fair value write-downs that bank regulators required for Other Real Estate Owned ("OREO"). Insurance company taxpayers responded by pointing out that the OTTIs, and even those OTTIs based on fair value, were not the type of "mechanical" fair value write-downs applicable to banks' OREO holdings and that the statutory write-downs involved the type of credit analysis which the IRS held in Rev. Rul. 84-95 was required.

As a result of the above-described issues and others, insurance company taxpayers and LB&I examiners could not consistently come to an agreement in the examination setting regarding the application of the conclusive presumption and the worthlessness determination. LB&I examiners issued Information Document Requests ("IDRs") seeking information about actual liquidations and, in the alternative, the voluminous details of the analysis that supported the OTTIs. Taxpayers found it difficult to answer these IDRs and to explain the complexities of their statutory accounting OTTI decisions to the satisfaction of the examiners. These problems led to extended examinations and controversy over the OTTIs, and, in the end, un-agreed issues. Most examiners set up proposed disallowances of all OTTI amounts in excess of the actual liquidations described in remittance reports.

Selected issues are placed on the priority guidance list and the IRS fields teams of specialists including LB&I examiners and chief counsel attorneys to consider the issues.

THE INDUSTRY ISSUE RESOLUTION (IIR) PROGRAM

The IIR program is described in Revenue Procedure 2003-36, *supra*. Under the program, industries or large segments of industries are encouraged to resolve issues with the IRS through the priority guidance process. The industries or industry segments submit issues for consideration and the IRS considers the applications at least twice per year, after March 31 and after Aug. 31. Selected issues are placed on the priority guidance list and the IRS fields teams of specialists including LB&I examiners and chief counsel attorneys to consider the issues. The issues can result in different types of guidance, including formal Revenue Procedures such as those referenced above that resolved telecommunications, power transmission and retail issues, or field directives such as the insurance company bad debt guidance described in this article. Revenue Procedure 2003-36 describes the following five issue characteristics that are important in the IRS' decision whether to include a proposed issue in the program:

1) The proper tax treatment of a common factual situation is uncertain;
2) The uncertainty results in frequent, and often repetitive, examinations of the same issue;

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3) The uncertainty results in taxpayer burden;
4) The issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines;
5) The issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist the IRS in determining proper tax treatment.

The OTTI/bad debt issue had all of the above characteristics. Perhaps most important from the IRS' perspective may have been the resource issue. Insurance company examinations are among the most complex examinations, both in terms of the facts and law. There are a limited number of examiners and financial products specialists who are qualified to examine large insurance companies. In many cases, the bad debt issue was the primary un-agreed issue proposed for adjustments to taxable income. It seems that the examination resources could have been better utilized by moving on to other matters. Another important consideration from the IRS' perspective appeared to be widespread support for the IIR process from the industry. The initial IIR request was submitted by a very substantial industry coalition of large companies covering both life and property-casualty segments; and the trade associations were included in the process.

From the insurance industry's perspective, the bad debt issue was an ideal candidate for IIR resolution. As mentioned above, many insurance companies reported partial worthlessness deductions that resulted in examination issues for pre-credit crisis years. Even before the financial crisis, it was evident that the examination procedures for complex instruments like mortgage-backed or other asset-backed securities were very tedious and time-consuming for both parties, and were prone to subjective judgments that would inevitably result in inconsistent treatment of taxpayers. In the aftermath of the financial crisis, the issue became widespread and resulted in substantial uncertainty over the timing of the deductions. In addition to the uncertainty, the issue resulted in long, complex examinations and comprehensive IDR responses that consumed personnel resources not only in tax departments but in the investment and accounting departments of insurance company taxpayers. The IIR process offered an opportunity to resolve the issue without individual companies having to continue to expend resources on examinations, and the issue was susceptible to a resolution that both the IRS and the industry could abide.

The insurance industry so far has a good track record in the IIR program. Early in the IIR program, the IRS resolved an important issue that affected the health insurance industry. After receiving substantial input from the industry through the IIR process, the IRS held in Revenue Procedure 2004-41[9] that accrued incentive payments not yet paid to doctors but included in Loss Adjustment Expenses were not disallowed under I.R.C. § 404 under certain circumstances. This is not to say that the IIR process has no risk for the industry or that companies can completely avoid resource outlays. During the process, the industry is required to fully illuminate the issue for the IRS and it is possible the IRS can disagree on a resolution, as much as both parties would like to reach a mutually acceptable resolution. Also, the process requires a substantial outlay of time and resources. The types of issues that the IRS considers often involve industry practices and accounting rules that must be explained in detail in order for the IRS to gain comfort with the issues.

The authors have participated in two insurance industry IIRs, including the bad debt issue and the ongoing (as of the date of this writing) issue concerning gains and losses on hedges of variable annuity minimum guarantee riders. On reflection, there are three things that are needed from an industry's perspective for a successful IIR resolution. First, the industry group must be prepared to devote substantial resources to the project. Second, there must be broad agreement or consensus in the industry or industry segment from the beginning of the process. Third, the industry must enter the process with an idea regarding how the issue can be resolved but approach the process with flexibility. The IRS has shown a willingness to give serious consideration to the industry's input and point of view, but the industry must be prepared to make compromises in order to reach a mutually acceptable resolution.

THE IIR REQUEST AND PROCESS

In light of the substantial uncertainty and resource drain from partial worthlessness examinations, a coalition within the industry thought that the work involved in seeking broad-based resolution of this issue through the IIR process would be well worth the risk and the required effort. The coalition initially consisted of seven companies from both the life and property-casualty segments that wrote approximately $100 billion in premiums in 2009. The coalition submitted a letter dated Sept. 30, 2010 to the IRS requesting an IIR project that would lead to guidance on the following three points:

(1) Confirmation that the conclusive presumption of worthlessness in Treas. Reg. § 1.166-2(d) applies to insurance companies as "other regulated corporations";

(2) The scope of the presumption as it applies to the charge-offs required by state insurance regulators;

(3) Relief to companies and state insurance regulators from technical compliance burdens.

While the coalition represented a broad swath of the industry, and there were indications from the outset that the IRS had an interest in applying the IIR process to this issue, it was thought that a broader indication of industry support may be helpful. On March 8, 2011, the ACLI submitted a letter supporting the coalition group's initial request for guidance. Shortly thereafter, the IRS notified both the coalition group and the ACLI that the request had been accepted for inclusion in the IIR program. The coalition group expanded to include more companies and property-casualty trade groups also joined in the process, resulting in very broad participation on the part of the insurance industry.

Because the initial industry submission had requested application of the conclusive presumption of worthlessness, the IIR process was initially referred to as the "Conclusive Presumption of Worthlessness IIR" or "CPW IIR." Within a couple of months from the time the project was accepted into the IIR program, the industry began to provide comprehensive information to the IIR team. The process ebbed and flowed but continued through 2011 and into 2012. During the process, the industry explained the statutory accounting for various types of debts, provided its views on the operation of the conclusive presumption of worthlessness, described the capital structures of investments in RMBS and CMBS structured securities, and described industry practices on OTTIs, among other things.

As the IIR process unfolded, the coalition requested guidance and proposed a resolution that would be based on the conclusive presumption of worthlessness and would cover all types of debts eligible for partial worthlessness, including REMIC regular interests, direct mortgages and other debts. As mentioned above, however, the IIR process requires flexibility and compromise. Moreover, the process is fluid and involves an element of pragmatism. The IRS's IIR team understandably wanted a thorough understanding of the statutory accounting and practices that underlie the OTTI deductions. Substantial effort was involved in explaining not only the OTTI determination and statutory accounting rules for different types of debts, but also the complex capital structures of the structured securities that qualify as non-securities eligible for partial worthlessness deductions. In the end, however, the IRS decided not to directly address the conclusive presumption of worthlessness and limited its guidance to the structured debt instruments subject to Statement of Statutory Accounting Principles 43R (SSAP 43R).

SSAP 43R OTHER-THAN-TEMPORARY IMPAIRMENTS

The resolution that ultimately emerged from the IIR process revolves around the statutory accounting rules for OTTIs on loan-backed and structured securities. For purposes of understanding the discussion that follows, it is necessary to briefly describe those statutory accounting rules. SSAP 43R provides a two-step process for impairments of these types of securities. First, if the fair value of a loan-backed or structured security is less than amortized cost, the company must assess whether the impairment is other than temporary. Then, if the present value (using the book yield) of the cash flows expected to be collected is less than amortized cost, a credit-related decline in value exists and an OTTI is considered to have occurred. In such case, the security is written down to the amount of the discounted value of the expected cash flows. Further, if the investor either intends to sell the impaired security, or does not intend to sell but is unable to demonstrate the intent and the ability to retain the security until recovery of amortized cost, the entire difference between amortized cost and fair value is recognized as a realized loss. In other words, in these latter cases, there may be an element of "market" or non-credit-related loss embedded in the impairment.

THE LB&I COMMISSIONER'S DIRECTIVE (THE DIRECTIVE)—

On July 30, 2012, LB&I Commissioner Heather Maloy issued a Directive to LB&I examiners that provides a safe harbor approach to resolve the partial worthlessness issue for eligible debts that are subject to SSAP 43R. Below is a summary of key provisions of the Directive.

1. *Application.* An insurance company may first apply the provisions of the Directive no earlier than the company's 2009 taxable year and no later than its 2012 taxable year (the "Adjustment Year"). The Directive provides that LB&I examiners should not challenge an insurance company's partial worthlessness deduction under I.R.C. § 166(a)(2) for eligible securities if the company complies with the following:

- In the Adjustment Year, the company's partial worthlessness deduction for eligible securities is the same amount

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as its SSAP 43R credit-related charge-offs for the same securities as reported in its Annual Statement, reduced or increased by an adjustment.

- o The adjustment is determined on Dec. 31 of the adjustment year and is the difference between (i) the tax basis of eligible securities over (ii) the statutory carrying value of the same securities increased by any non-credit-related portion of any charge-off not allowed as a deduction under the Directive.
- o In other words, a true-up is determined for eligible securities still owned at Dec. 31 of the adjustment year, and the tax basis of those eligible securities is set equal to (and not less than) the statutory carrying value of those securities as increased by any non-credit related charge-offs with respect to those securities.
- o As a result of this true-up, the Adjustment Year partial worthlessness deduction may be a negative amount, in which case the Directive requires it to be treated as an item of income.

- Following the Adjustment Year, the company's partial worthlessness deduction is the same amount as the company's SSAP 43R credit-related impairment charge-offs for the same securities as reported in its Annual Statement.
  - o However, the partial worthlessness deduction cannot reduce the tax basis of an eligible security below its statutory carrying value as increased by any non-credit related impairment.
  - o Although subsequent adjustments were discussed at various stages throughout the IIR process, the Directive itself is silent on the matter. Thus, while tax basis and statutory carrying value of the impaired securities are set equal on Dec. 31 of the Adjustment Year, that will not necessarily be the case going forward.

If the company complies with both of these requirements, the Directive instructs LB&I examiners not to challenge the company's partial worthlessness deduction for eligible securities for all open years ending before the Adjustment Year. That is, the company is given audit protection for prior open years.

In allowing the company to choose 2009, 2010, 2011 or 2012 to be the Adjustment Year, the Directive provides welcome flexibility. 2009 was chosen as the first available Adjustment Year because that is the year in which SSAP 43R became effective. By not allowing companies to choose an adjustment year after 2012, the Directive prevents gaming the system so, for example, a company cannot take excessive partial worthlessness deductions on its 2012–2014 returns, choose 2015 as the Adjustment Year, and claim audit protection for prior open years that include the excessive deductions. However, as a consequence, the Directive will not be applicable to new companies formed after 2012 including, presumably, companies acquired in a transaction for which an I.R.C. § 338(h)(10) election is made. On the other hand, existing companies may want to apply the Directive even if there is no adjustment at the end of the Adjustment Year and/or they are not in need of audit protection for prior years, in order to follow the method of accounting allowed by the Directive in future years. Application of the Directive within an affiliated group of companies is made on a company-by-company basis, even for those companies that join in the filing of a consolidated tax return.

2. *Definitions*. Important provisions of the Directive are embodied in the definitions. "Eligible securities" are defined as investments in loan-backed and structured securities within the scope of SSAP 43R, subject to I.R.C. § 166 (and not subject to I.R.C. § 165(g)(2)(c)), including REMIC regular interests. Accordingly, while application of issue resolution to partial worthlessness of other types of debts was discussed during the IIR process, the Directive is of more limited scope. The Directive also requires that there be a "charge-off" of the eligible securities in the Annual Statement—meaning that there must be a reduction of the carrying value of the debt that results in a realized loss or charge to the statement of operations (as opposed to recognition of an unrealized loss).

   Of further note, the term "insurance company" is defined as a life or non-life insurance company that 1) is subject to regulation as an insurance company, 2) is subject to taxation under I.R.C. Subchapter L, and 3) files an Annual Statement for which a state regulator has examination authority. "Annual Statement" is defined as the Annual Statement approved by the NAIC which an insurance company is required to file with insurance regulatory authorities of a state. Thus, a foreign insurance company that has made an election under I.R.C. § 953(d) to be taxed as a domestic insurer would not be allowed to apply the Directive as it would not qualify as an insurance company within the meaning of the Directive.

3. *Consistency Requirement.* The industry's safe harbor proposals discussed during the IIR process would have al-

lowed an insurance company to pick and choose the eligible securities to which it would apply the safe harbor method. This would have been in accordance with applicable law which allows, but does not require, a company to claim a partial worthlessness deduction when there has been a book charge-off. However, in order for the Directive to apply, an insurance company must use the SSAP 43R credit-related impairment charge-off amount for all eligible securities that are partially worthless. This requirement provides a measure of protection for the IRS against possible adverse selection.

4. *Implementation.* The Directive provides different implementation procedures for companies under examination and those not under examination. For a company under examination, LB&I examiners, in consultation with the company, will decide whether the most appropriate way to implement the Directive is 1) to have the company file amended tax returns, or 2) change the amount of the partial worthlessness deduction for the years under examination as part of the examination process. An insurance company that is not under examination may apply the Directive either by filing amended tax returns or by first applying the Directive to its current taxable year. In either case, it must attach a statement to the tax return for the Adjustment Year stating that it is implementing the Directive. For a consolidated return group, a separate statement is required for each company that elects to apply the Directive.

5. *Certification*. When the industry approached the IRS on this matter, it sought relief from cumbersome, perhaps unworkable, rules set forth in the Treasury Regulations for compliance with the conclusive presumption of worthlessness. Those regulations provide that a debt shall, to the extent charged off during a taxable year, be conclusively presumed to have become worthless during the taxable year if the charge-off is either 1) in obedience to the specific orders of regulatory authorities, or 2) in accordance with established policies of such authorities, and, upon their first audit subsequent to the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off. This latter subsequent confirmation procedure essentially requires a company to claim a deduction for partial worthlessness before it can be established that it has satisfied the requirements of the regulations. As a practical matter, in an effort to satisfy the conclusive presumption of worthlessness regulations prior to the IIR process, an insurance company may have sought a letter from its domestic insurance department acknowledging that charge-offs in accordance with the applicable SSAP would be required upon examination if the company had not made them.

The industry's safe harbor proposal would have simplified the confirmation process by providing that the company certify in a letter to its regulator, or disclose in a footnote or schedule in its Annual Statement, 1) the amount of the charge-off that is in compliance with SSAP 43R, 2) the post-impairment statutory carrying value of the debt, and 3) if there is a non-credit-related portion of the charge-off, the amount of that portion. However, because the Directive does not directly address the conclusive presumption of worthlessness regulations, it provides a different certification requirement in the form of a Certification Statement. An insurance company that applies the Directive must complete and sign the Certification Statement and provide it to the LB&I examiner within 30 days of a request for the statement. A separate certification statement may be requested for each taxable year and for each insurance company in a consolidated return group. A company that fails to comply with the certification requirement will be considered ineligible for application of the Directive and instead subject to regular audit procedures.

The Certification Statement requires the following information:

- Amount of Annual Statement charge-off for eligible securities in compliance with SSAP 43R
- Post-impairment statutory carrying value of eligible securities under SSAP 43R
- Post-impairment tax basis of eligible securities
- Non-credit relation portion of the Annual Statement charge-off, if any
- Positive or negative adjustment to the partial worthlessness deduction determined on Dec. 31 of the Adjustment Year

The statement, which must be signed by a person authorized to execute the company's tax return, certifies under penalties of perjury that 1) the amount of the SSAP 43R credit-related impairment charge-offs are the same as partial worthlessness deductions claimed on the tax return with respect to the same securities, and 2) the tax basis of eligible securities is not less than their post-charge-off

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statutory carrying values as adjusted for any non-credit impairment. The company must retain (and provide to the IRS upon request) the underlying documentation that would permit the LB&I examiner to reconcile the Annual Statement charge-offs with the partial worthlessness deductions. Failure to properly and timely submit the requested documentation may result in a determination by the Industry Director or delegate that the Directive does not apply to the company.

CONCLUSION

While perhaps taking a longer period of time to resolve than the parties may have anticipated at the outset, the IIR process for partial worthlessness deductions for insurance company bad debts ultimately reached a satisfactory conclusion for both the industry and the IRS. The IRS' dedication of resources, time and effort to the process—right up to the top levels of LB&I—was very impressive. The industry was given a full and fair hearing of its views at each step of the process, even to the very end when the Directive was issued in response to the industry's request for guidance that could be taken into account on 2011 tax returns on a timely basis. The Directive provides a fairly simple, yet flexible and very effective, methodology for allowing partial worthless deductions for securities such as REMIC regular interests while providing audit protection for prior open years. The time and expense savings to both the industry and the IRS from application of the Directive, through avoidance of extended controversy and perhaps litigation, are expected to be enormous. In addition, the prospect of inconsistent treatment of similarly situated companies has been greatly reduced. This is a good example of how the tax law can be administered in a fair and reasonable manner.

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END NOTES

[1] Rev. Proc. 2003-36, 2003-1 C.B. 859 (April 18, 2003).

[2] *See, e.g.*, Rev. Proc. 2011-42, 2011-37 I.R.B. 318 (Aug. 19, 2011) and Rev. Proc. 2011-43, 2011-37 I.R.B. 326 (Aug. 19, 2011) (providing safe harbor approaches for capitalization issues in the electric power transmission industry); Rev. Procs. 2011-22, 2011-18 I.R.B. 737 (April 4, 2011), 2011-27, 2011-18-I.R.B. 740 (April 4, 2011) and 2011-28, 2011-18 I.R.B. 743 (April 4, 2011) (providing safe harbors for capitalization and depreciation of network assets in the telecommunications industry); Field Directive on Treatment of Sales-Based Vendor Allowances ("SBVA") and Margin Protection Payments ("MPP") under § 471, LMSB-04-0910-026 (Sep. 24, 2010) (providing resolution of treatment of SBVAs and MPPs). Other IIR resolutions involving a variety of issues and industries are described on the IRS website at http://www.irs.gov/Businesses/IIR-Guidance-Issued.

[3] I.R.C. § 166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012). The IRS is working on another IIR insurance issue involving the treatment of gains and losses on hedges related to minimum guarantees on variable annuity contracts. It is hoped that hedging guidance will emerge by the time this article is published.

[4] *See ACLI Life Insurers Fact Book 2009.*

[5] *NAIC Capital Markets Weekly Special Report* (July 29, 2011).

[6] *See* I.R.C. § 166(e) and Treas. Reg. § 1.166-1(g), which limit the deductions to debts that are not securities.

[7] *See* Samuel A. Mitchell and Peter H. Winslow, *Insurance Company Bad Debt*, 19 *Taxing Times*, Vol. 7, Issue 3 (September 2011).

[8] Rev. Rul. 84-95, 1984-2 C.B. 53 (July 2, 1984).

[9] Rev. Proc. 2004-41, 2004-2 C.B. 90 (July 6, 2004).

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DETERMINING "PREMIUMS PAID" FOR PURPOSES OF APPLYING THE PREMIUM EXCISE TAX TO FUNDS WITHHELD REINSURANCE

By Brion D. Graber

Since 1917, the federal tax law has included an insurance excise tax.[1] Over the last century, various modifications and refinements have occurred, but the excise tax remains. In its current form, I.R.C. § 4371 imposes an excise tax on policies issued by foreign insurers or reinsurers covering U.S. risks.[2] The rate of tax is 4 percent of each dollar of premium paid for property and casualty insurance and 1 percent of each dollar of premium paid for life, sickness, or accident insurance or for reinsurance. The beneficiary of the policy and any person who issues or sells the policy are jointly and severally liable for the tax, although the Internal Revenue Service (the "IRS") generally looks to the person making the premium payments for the tax. Certain U.S. income tax treaties waive the excise tax if conditions specified in the treaty are satisfied.

The basic structure of the premium excise tax is simple, but its application to actual transactions can raise difficult questions. One particular area that raises issues is funds withheld reinsurance, a type of indemnity reinsurance. In a funds withheld reinsurance arrangement, the ceding company typically retains the initial premium due the reinsurer, usually in an amount equal to the statutory reserves attributable to the business identified in the reinsurance agreement. The ceding company withholds the funds to permit statutory reserve credit for non-admitted reinsurance, to reduce the ceding company's potential credit risk, or to retain control over investments. The ceding company and reinsurer establish accounting records that allow the parties to track increases and decreases in the net balance of the funds withheld. The ceding company uses the funds withheld to satisfy obligations of the reinsurer, such as expense reimbursement and the payment of claims. The net balance of the funds withheld increases or decreases over time as the reserves increase or decrease, surplus is repaid, and profit emerges. An investment adjustment is made each period to reflect the fact that the ceding company is holding the reinsurer's assets.

Except for the reinsurer's risk charge (the portion of the reinsurance premium that the reinsurer retains for providing the reinsurance), cash is not typically transferred between the ceding company and the reinsurer until the net balance of the funds withheld equals zero. The reinsurance is typically terminated once the net balance reaches zero because there is little need for continuing reinsurance coverage. If termination occurs prior to that time, the assets held by the ceding company on behalf of the reinsurer are "returned" to the ceding company.

In an audit technique guide released on the IRS website in October 2008, the IRS expressed its view on the application of the premium excise tax to funds withheld reinsurance. The IRS asserted that:

> In determining when premiums are paid, and thus subject to the tax, the accrual method of accounting, not the cash-basis method of accounting applies. Revenue Ruling 77-453, 1977-2 C.B. 237, and G.C.M. 37,201 (July 26, 1977) support an interpretation of the term "amounts paid for reinsurance" under IRC § 832(b)(4) as including amounts accrued as well as amounts actually paid. Ceded premiums are considered paid to the reinsurer when all events have occurred that fix the reinsurer's right to the premiums and the amount of such premiums is reasonably ascertainable.[3]

The IRS did not provide a further explanation of this position. It did state that some taxpayers have taken the position that the premium excise tax applies only to actual transfers made by the ceding company to the reinsurer, which it called "an incorrect position."[4] It also stated that some taxpayers have taken the position that the excise tax applies only to the net amount of the ceded premiums.

No authority directly addresses this question, so taxpayers and the IRS are left with the plain language of the statute and Treasury regulations, as well as authorities addressing other tax provisions they believe provide relevant analogies, to determine the proper application of the premium excise tax to funds withheld reinsurance. Several of these authorities are discussed below, including those briefly mentioned in the audit technique guide. As that discussion demonstrates, the IRS position expressed in the audit technique guide is questionable. The underlying flaw in the IRS position is that it

seeks to apply an income tax accounting concept (the accrual method of accounting) to an excise tax.[5] Excise taxes are generally imposed on a transaction, which contemplates a specific event. The issue with the premium excise tax, therefore, is identifying when the tax attaches and measuring the tax at that time. In contrast, an income tax is concerned with determining a net taxable amount that takes into account many events occurring during a taxable year. While the accrual method of accounting has great relevance in that context, it has little utility in the excise tax context.

THE TAXPAYER POSITION

In examining this question, one begins with the statute and the relevant Treasury regulations. I.R.C. § 4371(3) states that a 1 percent excise tax is imposed "on each dollar, or fractional part thereof, of the premium paid on the policy of reinsurance." Treas. Reg. § 46.4371-3(b) provides that "the term 'premium payment' means the consideration paid for assuming and carrying the risk or obligation, and includes any additional assessment or charge paid under the contract, whether payable in one sum or installments." Consistently, Treas. Reg. § 46.4374-1(b) provides that liability for the tax "shall attach at the time the premium payment is transferred to the foreign insurer or reinsurer (including transfers to any bank, trust fund, or similar recipient, designated by the foreign insurer or reinsurer), or to any nonresident agent, solicitor, or broker." Recognizing the nature of an excise tax, each of these provisions requires that an actual premium payment occur before the excise tax may apply, and then it applies only to that specific payment.

LEGISLATIVE HISTORY

Prior to 1965, I.R.C. § 4371 measured the excise tax according to the "premium charged" and I.R.C. § 4374 required that the tax be paid by stamp. In the Excise Tax Reduction Act of 1965 (the "1965 Act"), Congress amended those provisions to permit the payment of the excise tax by return.[6] In addition, the 1965 Act required the tax to be based on the "premium paid" rather than the "premium charged" if the tax was paid by return. In the Tax Reform Act of 1969 (the "1969 Act"), Congress again amended I.R.C. § 4371 to reflect the implementation of a return system. The 1969 Act required the tax to be measured by the "premium paid" in lieu of the "premium charged" in all cases.[7] These changes reflect a congressional intent to measure the premium by the actual payment rather than the gross premium "charged."

OTHER PROVISIONS WHERE PAYMENT MEANS ACTUAL PAYMENT

The rule that "when a statute says paid it means actual payment," is found in numerous instances throughout the Code in addition to the regulations under the premium excise tax. Examples exist under the income tax provisions, the withholding tax provisions, the information return provisions, and even the other excise tax provisions.

While the accrual method of accounting has great relevance in that context, it has little utility in the excise tax content.

For example, I.R.C. § 461(h)(2)(C) of the income tax provisions provides that in certain circumstances economic performance does not occur until "a payment to another person." Treas. Reg. § 1.461-4(g)(1)(ii)(A) defines payment as having "the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment." It gives as examples of a payment the furnishing of cash or cash equivalents and the netting of offsetting accounts. It also states that payment does not include the furnishing of a note, a promise to provide services or property in the future (whether or not evidenced by a contract or other written agreement), or an amount transferred as a loan, refundable deposit, or contingent payment. Other income tax provisions provide similar examples.[8]

The withholding tax provisions also make clear that payment as used in the Code does not contemplate an accrual concept. For example, I.R.C. § 3406(a) imposes backup withholding on certain reportable "payments." Treas. Reg. § 31.3406(a)-4(a)(1) provides that if backup withholding is required:

> The payor must withhold at the time it makes the payment to the payee or to the payee's account that is subject to withholding. Amounts are considered paid when they are credited to the account of, or made available to, the payee. Amounts are not considered paid solely because they are posted (e.g., an informational notation on the payee's passbook) if they are not actually credited to the payee's account or made available to the payee.

Similarly, I.R.C. § 3402 imposes income tax withholding on employers making "payment" of wages.[9]

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A transfer of cash from a ceding company to a reinsurer is perhaps the most obvious example of a payment.

I.R.C. § 6041(a), an information return provision, requires reporting on a "payment" made of certain income items. For this purpose:

> an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.[10]

Treas. Regs. §§ 1.6049-1(b) and 1.6044-2(c) contain substantially similar language with respect to interest and dividends, respectfully.

Notwithstanding the structure and language of I.R.C. § 4371, other types of excise taxes are not generally imposed on "payments" or amounts "paid." Nevertheless, there are exceptions. I.R.C. §§ 4261 and 4271 impose excise taxes on certain amounts "paid" for air transportation. These taxes accrue at the time of actual payment, irrespective of when the transportation is provided.[11]

THE SUPREME COURT

Consistent with the interpretations of payment or paid in each of the above examples is the holding of the Supreme Court in *Don E. Williams Co. v. Commissioner*.[12] In that case, the Court rejected the argument that when the Code requires an amount to be "paid," it incorporates the taxpayer's method of accounting. The Court explained that when Congress intends to adopt an accrual standard it uses the phrase "paid or accrued" or "paid or incurred." In contrast, when Congress merely uses the term "paid," it intends a cash basis standard, regardless of the taxpayer's general accounting method. The Court's view is long-standing,[13] and has repeatedly been relied on by the courts and the IRS.[14] Nevertheless, the audit technique guide makes precisely the same argument rejected by the Court—namely, that the term "paid" in I.R.C. § 4371 incorporates the taxpayer's accrual method of accounting.

I.R.C. § 848 REGULATIONS

While the regulations under I.R.C. § 4371 do not specifically address funds withheld reinsurance, the I.R.C. § 848 regulations provide some guidance. I.R.C. § 848 requires insurance companies to capitalize and amortize specified policy acquisition expenses. The amount of such expenses is determined by application of a percentage to the excess of (1) the gross amount of premiums and other consideration over (2) return premiums and premiums and other consideration incurred for reinsurance. The regulations make plain that, in the case of funds withheld reinsurance, the premiums subject to I.R.C. § 848 are considered to be the *net* amount transferred to the reinsurer.[15] This net amount is not grossed up for expenses that are netted against the amounts due the reinsurer.

WHAT CONSTITUTES A PAYMENT?

The above authorities consistently show that the premium excise tax applies only to "payments," thus requiring an understanding of what is a payment. A transfer of cash from a ceding company to a reinsurer is perhaps the most obvious example of a payment. The delivery of a check similarly constitutes a payment, assuming it is honored in due course.[16] A distinction is made, however, between a check and a note, even when the note may be a cash equivalent. "[A] promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets."[17] Thus, in *Don E. Williams*, the Court rejected the argument that the taxpayer's issuance and delivery of an interest-bearing promissory note that was secured by collateral and guaranteed by persons with substantial net worth constituted a payment. Even under these circumstances, the note was merely a promise to pay, which might never be fulfilled.

In the case of funds withheld reinsurance, it is apparent that the ceding company makes a payment to the reinsurer to the extent that it transfers cash (or a check) to the reinsurer. It is equally apparent that the fact that the ceding company has promised under the reinsurance agreement to pay the reinsurer for assuming certain risks does not constitute a payment. Cash and checks, however, are not the only means of making a payment.

A payment may also occur by offset against a debt owed[18] or when a creditor applies property in its possession against a debtor's liability.[19] In *Jergens v. Commissioner*, for example, the taxpayer was determined to have made interest payments when his employer paid interest the taxpayer owed to third parties and offset those amounts against the compensation the employer owed to him. The Tax Court rejected the IRS's argument that the taxpayer had not made a payment because he had not suffered a cash detriment. To the contrary, "[i]n each

of the taxable years [taxpayer's] personal account attained a credit balance after the debits were made and he suffered a cash detriment to the extent of the charges made to his account. On the facts, we cannot hold that the requisites for cash basis payments were not met."[20]

Authorities, such as *Jergens*, that state a payment occurs when there is an offset are quite instructive in the context of funds withheld reinsurance. Offsets regularly occur with funds withheld reinsurance. Whenever the ceding company pays an amount that the reinsurer has agreed to reimburse (such as a claim on the portion of a policy that the reinsurer has assumed), the result is a reduction in the amount that the ceding company owes to the reinsurer. Thus, even though no cash is directly transferred from the ceding company to the reinsurer, these authorities support a conclusion that there has been a payment.

THE IRS POSITION

As previously stated, the 2008 audit technique guide reaches a different conclusion from the taxpayer position discussed above, stating that an accrual concept is used to determine the premium payments to which the premium excise tax applies. The audit technique guide does not discuss any of the above authorities, all of which are contrary to its position. Rather, it briefly refers to Rev. Rul. 77-453[21] and G.C.M. 37,201.[22] Separately, it includes a citation to Rev. Rul. 79-138.[23] These authorities are discussed below.

REV. RUL. 77-453

In Rev. Rul. 77-453, the IRS considered when, for purposes of I.R.C. § 832(b)(4), it is appropriate for a ceding company to reduce gross premiums by the amount of reinsurance premiums and, similarly, when a reinsurer should include those same premiums in its gross premiums. The IRS states that for this purpose reinsurance premiums reduce gross premiums written as opposed to being a deductible expense. Once the risks related to the reinsured policies have been shifted to the reinsurer, the ceding company is merely an agent with respect to those risks, and thus cannot earn premiums with respect to them.[24] Accordingly, the ceding company should reduce its gross premiums "when the risks under the reinsured contracts have shifted … and the amount of the reinsurance premium is reasonably ascertainable." As for the reinsurer, it should include in gross premiums "the amount of the reinsurance premium that it has a fixed right to receive under the reinsurance treaty when the amount is reasonably ascertainable."

Rev. Rul. 77-453 does not provide much explanation of its conclusion, but a more robust discussion is found in G.C.M. 37,201, which was prepared in connection with the ruling. In particular, the G.C.M. considers the argument that when I.R.C. § 832(b)(4)(A) allows a deduction for "premiums paid for reinsurance" in calculating premiums earned, it means that a ceding company cannot reduce its gross premiums written until there has been an actual payment of reinsurance premiums. The G.C.M. rejects that argument, concluding that gross premiums should be reduced when the risks on the reinsured policies are transferred to the reinsurer, "which is when all events have occurred to fix the obligation, and the amount of the premiums can be determined with reasonable accuracy." Critically, the G.C.M. states that this conclusion prevents the "absurd and inequitable" result in which both the ceding company and the reinsurer are taxed on the same premium income in the same taxable year as might happen if I.R.C. § 832(b)(4)(A) was interpreted to require an actual payment before the ceding company could reduce its gross premiums written.

Significantly, the possibility of double taxation, which Rev. Rul. 77-453 seeks to avoid, is not present in a situation in

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which one is trying to determine the proper treatment of funds withheld reinsurance for purposes of the premium excise tax. The only issue in such a case is the amount of the premiums to which the premium excise tax will apply; there is no possibility that the tax will be collected more than once on those same premiums. Moreover, the audit technique guide does not explain why this revenue ruling, which addresses issues under I.R.C. § 832, is of greater relevance in determining the application of the I.R.C. § 4371 excise tax than the numerous other Code provisions (some of which are discussed above) that make plain payment requires an actual payment.

REV. RUL. 79-138

The audit technique guide states that the amount of premiums paid, and thus subject to the excise tax, should not be reduced by any allowance due the ceding company from the reinsurer. Rev. Rul. 79-138 is cited as support for this statement, though it is unclear how, if at all, the audit technique guide believes it should apply to funds withheld reinsurance.

In Rev. Rul. 79-138, the IRS considered how the premium excise tax should apply to two situations involving coinsurance. In the first, the ceding company agreed to pay the reinsurer its proportionate share of the premiums received on the policies covered by the reinsurance agreement, and the reinsurer agreed to bear its proportionate share of all losses and loss adjustment expenses. The reinsurer also agreed to pay the ceding company a ceding commission equal to 42 percent of the net premiums received. For convenience, it was agreed the ceding company would remit to the reinsurer only the net amount of the gross premiums less the ceding commission and the reinsurer's share of any losses and loss adjustment expenses. The second situation was similar to the first, except the agreement merely called for the ceding company to pay the reinsurer an amount equal to 58 percent of the net premiums attributable to the reinsurer's share of the risk.

The IRS concluded that in "determining the amount of a premium paid … the law does not provide for reduction of the gross premium paid for expenses incurred in connection with underwriting the taxable insurance contract." Thus, the premium excise tax applied to the proportionate share of the premiums received by the ceding company that were attributable to the foreign reinsurer not reduced by any ceding commission, losses, or loss adjustment expenses. In the second situation, the premium excise tax still applied to the proportionate share of the gross premiums received by the ceding company, even though the reinsurance agreement required payment of only a net amount. The IRS stated the same conclusions would apply to modified coinsurance.

By its terms, Rev. Rul. 79-138 applies to coinsurance and modified coinsurance, but not to funds withheld reinsurance. The issue with funds withheld reinsurance is determining when there is a payment to which the premium excise tax applies. The revenue ruling concludes that when there is an actual payment and expense items that are obligations of the reinsurer (such as losses and loss adjustment expenses) are netted against premiums otherwise due the reinsurer, the premium excise tax applies to the gross amount of the payment made by the ceding company. To the extent this holding states that a cash basis taxpayer will be considered to have paid an amount in circumstances in which there are concurrent debits and credits to a cash basis taxpayer's account, it merely restates the well-established proposition discussed above.[25] To the extent it holds that the premiums paid by the ceding company should be determined without reduction for the ceding commissions due from the reinsurer, it is asserting a position contrary to *National Capital Insurance Co*., which held that premiums paid to a reinsurer should be computed net of ceding commissions.[26] In such a case there is no actual payment. In any event, in the case of funds withheld reinsurance, the types of offset contemplated by the revenue ruling do not normally occur immediately upon entry into a reinsurance agreement, which is why Rev. Rul. 79-138 addresses only coinsurance and modified coinsurance.

TERMINATION

The audit technique guide states that when there is a cancellation of a policy, amounts that are refunded or credited are return premiums that result in a reduction in the premium subject to the premium excise tax.[27] Under the IRS position, the ceding company will have paid the premium excise tax on the entire initial premium. However, when the reinsurance agreement is terminated, as is likely to happen, a portion of the funds withheld may be "returned" to the ceding company. If the IRS position is followed and the premium excise tax is imposed on an accrual basis, then the excise tax is negated to the extent it is later determined the funds withheld are returned. That is, the IRS position inappropriately requires that the premium excise tax be paid on too large an amount in the first instance, only to have a portion of that premium excise tax credited or refunded when the reinsurance agreement is subsequently terminated.[28] The taxpayer position discussed above avoids this

issue by having the ceding company pay the premium excise tax only on actual payments.

CONCLUSION

The IRS's position on the application of the premium excise tax to funds withheld reinsurance is clearly expressed in the 2008 audit technique guide—an accrual concept applies. The soundness of that position is less clear. Taxpayers that determine the excise tax by looking only to actual payments made by the ceding company to the reinsurer or to the net amount of the ceded premiums after adjusting for the allowance paid by the reinsurer have a variety of arguments to support their position. The language of the premium excise tax, the regulations thereunder, the legislative history of the provision, and the very nature of an excise tax all support the position that the tax applies only when there is an actual payment. Other Code provisions that use similar language as well as the Supreme Court also support this view.

Nevertheless, taxpayers that take a position that the excise tax applies to something less than all amounts due to the reinsurer for which all events have occurred that fix the reinsurer's right to the premiums and the amount of which is reasonably ascertainable should expect the IRS to challenge that treatment. The discussion of this issue in the audit technique guide suggests the IRS is prepared to raise this issue on audit. In time, increased attention may result in greater clarity, but for now it remains an area of potential dispute. ◂

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END NOTES

[1] War Revenue Act of 1917, Pub. L. No. 65-50, § 504, 40 Stat. 300, 315 (1919).

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Internal Revenue Service, *Foreign Insurance Excise Tax—Audit Technique Guide* (2008).

[4] *Id.*

[5] The IRS similarly seems to fail to appreciate the differences between income taxes and excise taxes in its position on the cascading premium excise tax as expressed in Rev. Rul. 2008-15, 2008-12 I.R.B. 633, and the audit technique guide. *See* Peter H. Winslow & Biruta S. Kelly, *IRS Foreign Insurance Excise Tax—Audit Technique Guide Presents Questionable Positions*, Taxing Times, May 2009, at 48.

[6] Pub. L. No. 89-44.

[7] Pub. L. No. 91-172.

[8] I.R.C. § 404(a) provides for a limitation on the deduction for contributions "paid" by an employer under a pension, annuity, stock bonus, or profit-sharing plan. The regulations provide that deductions under this section are "generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting." Treas. Reg. § 1.404(a)-1(c).

I.R.C. § 561(a) provides a deduction for certain taxpayers for dividends "paid" in the taxable year. A dividend is considered paid "when it is received by the shareholder." Treas. Reg. § 1.561-2(a)(1). This determination is in no way dependent on the corporation's method of accounting for keeping its books or determining its taxable income. Treas. Reg. § 1.561-2(b).

[9] "The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition." Treas. Reg. § 31.3402(a)-1(b).

[10] Treas. Reg. § 1.6041-1(h).

[11] Treas. Reg. § 49.4261-1(b).

[12] 429 U.S. 569 (1977).

[13] *See* Eckert v. Burnet, 283 U.S. 140, 141 (1931).

[14] *See, e.g.*, Black Gold Energy Corp. v. Commissioner, 33 F.3d 62 (10th Cir. 1994); Vander Moere v. Commissioner, T.C. Memo 1978-430; Rev. Rul. 81-262, 1981-2 C.B. 164; Rev. Rul. 80-140, 1980-1 C.B. 90.

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END NOTES CONT.

[15] Treas. Reg. § 1.848-2(f)(5). This treatment is illustrated in Treas. Reg. § 1.848-2(f)(9), Example 5, which involves a funds withheld reinsurance agreement in which the reinsurer is credited with an initial premium equal to the ceding company's reserves on the reinsured contracts. The reinsurer makes a loan to the ceding company in the same amount and is issued a note by the ceding company. The loan is netted against the reinsurance premium for I.R.C. § 848 purposes. Consequently, immediately after the agreement is entered into, no net consideration has been provided. As discussed in more detail in the next section of this article, the ceding company's issuance of the note does not constitute a payment for tax purposes.

[16] Belcher Est. v. Commissioner, 83 T.C. 227 (1984); Spiegel Est. v. Commissioner, 12 T.C. 524 (1949), *acq.*, 1949-2 C.B. 3.

[17] Don E. Williams, 429 U.S. 569 (1977); *see also* Helvering v. Price, 309 U.S. 409 (1940); Eckert v. Burnett, 283 U.S. 140 (1931); Foley v. Commissioner, T.C. Memo 1976-60; Rev. Rul. 76-135, 1976-1 C.B. 114.

[18] *E.g.*, Carroll v. Commissioner, 30 T.C.M. 249, 254-55 (1971); Jergens v. Commissioner, 17 T.C. 806, 808-09 (1951), *acq.*, 1952-1 C.B. 2.; Rosenblatt v. Commissioner, 16 T.C. 100, 104-05 (1951); Reynolds v. Commissioner, 44 B.T.A. 342, 355-56 (1941), *acq.*, 1941-2 C.B. 11.

[19] *See* Sherman v. Commissioner, 18 T.C. 746 (1952) (holding that a taxpayer was entitled to an interest deduction when a creditor foreclosed on collateral securing the loan on which the taxpayer owed the interest and applied the proceeds against the interest owed), *acq.*, 1952-2 C.B. 3, *acq. withdrawn on other issue and nonacq. substituted,* 1964-2 C.B. 9.

[20] *Jergens*, 17 T.C. at 809.

[21] 1977-2 C.B. 236.

[22] G.C.M. 37,201 (July 26, 1977).

[23] 1979-1 C.B. 359.

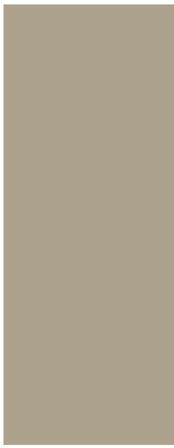
[24] *See* Colonial Surety Co. v. United States, 178 F. Supp. 600, 602 (Ct. Cl. 1959).

[25] *See, e.g., Jergens,* 17 T.C. at 808-09; Rosenblatt v. Commissioner, 16 T.C. 100, 104-05 (1951).

[26] 28 B.T.A. 1079 (1933). G.C.M. 37,201 (July 29, 1977), which was prepared in connection with Rev. Rul. 79-138, contends that the case does not control because of a subsequent change in the predecessor to I.R.C. § 832 that it argues would have resulted in a different outcome.

[27] *See also* Rev. Rul. 66-197, 1966-2 C.B. 478 (stating that the taxpayer may either claim a credit for the resulting excise tax overpayment on his next quarterly excise tax return or file a claim for refund).

[28] In addition, the IRS position may create a statute of limitations issue if the ceding company seeks a refund of the "excess" portion of the initial excise tax payment.



IT'S ABOUT BASIS … AND MOORE

By John T. Adney and Bryan W. Keene

In three cases decided last summer, the federal courts were asked to address the income tax "basis" associated with life insurance contracts. As detailed below, in two of those cases, the courts did so: *Dorrance* struggled with the longstanding question of how to allocate cost basis between shares of stock received in a demutualization and the life insurance contracts that gave rise to the shares, while *Brown* confirmed an Internal Revenue Service ("IRS") (and insurance company) calculation of the excess of contract termination proceeds over the policyholder's "investment in the contract" to determine the gain taxable to the policyholder. In the third case, however, the court in *Moore* dismissed the IRS' (and the insurer's) determination of basis and hence of contract termination gain, concluding instead that the contract had in fact terminated decades earlier.

THE DEMUTUALIZATION ISSUE: *DORRANCE V. UNITED STATES*

Since the modern wave of life insurance company demutualizations began in the 1980s, the IRS has expressed the view that the cost basis of a policyholder's shares of stock received in a demutualization is zero. The rulings that the IRS issued to demutualizing companies took this position despite the fact that the IRS, like most others, acknowledged that there was value associated with the participating contract rights, *i.e.*, to vote for mutual company directors and share in divisible surplus. That those rights had substantial value was evidenced by the fact that they ultimately were converted into shares of the demutualized company. That said, a precise dollar value has never been assigned to such participation rights, let alone to their cost. The IRS view essentially allocated all of the value arising from the premiums paid for life insurance contracts issued by former mutuals to the contracts' benefits apart from the participation rights.

Several years ago, in *Fisher v. United States,* 82 Fed. Cl. 780 (2008), *aff'd per curiam,* 333 Fed. App'x 572 (Fed. Cir. 2009), the IRS' "zero basis" view was challenged by a policyholder who received cash (in lieu of stock) from the demutualizing insurer in exchange for his participation rights. The policyholder, who maintained his life insurance contract in force after the demutualization, contended that his cost in acquiring the rights he gave up in return for the cash received—embedded in the premiums theretofore paid for the contract—was greater than zero but not determinable as a practical matter, and hence that the tax law's "open transaction" doctrine should apply. Under that doctrine, which is rarely invoked today, the determination of the gain (if any) in a sale or exchange is held open and not taxed to the recipient until the cost basis of the property sold or exchanged has been fully recovered. The Court of Federal Claims took the extraordinary step of adopting this approach, thereby allowing the policyholder to avoid federal income tax on the cash he received and deferring tax on the gain (if any) from the demutualization transaction until such time as the life insurance contract was surrendered. Moreover, if the contract continued in force until the death benefit was paid, the gain involved in the cash payment would likely never be taxed. The Federal Circuit Court of Appeals affirmed the lower court's ruling without opinion.

Essentially the same situation, and the same proposed resolution, was presented to the U.S. District Court for the District of Arizona in *Dorrance v. Commissioner*, 877 F.Supp. 2d 827 (D.Az 2012) . In that case, a life insurance trust established by the plaintiffs had the good fortune of purchasing sizeable life insurance contracts from some five mutual companies that demutualized not many years after the purchases. The trust thereby benefitted from the distribution of shares in each of those companies in connection with the demutualizations, and in turn it sold all of the shares for cash, but it continued to maintain the life insurance contracts in force. On the IRS Form 1099-B that the trust received as a result of the shares' sale, the basis of the shares was reported as zero, consistently with the IRS position, so the plaintiffs paid the tax due on the full value of the shares and then filed a claim for refund arguing that the open transaction doctrine applied. This led to the lawsuit.

The District Court agreed with the Court of Federal Claims that there was value in the participation rights subsumed in the shares distributed to the trust, but it disagreed with the latter's resolution of the tax issue *via* the open transaction doctrine. Responding to the plaintiffs' and the government's

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The five insurers involved in *Dorrance* perhaps could incorporate the ultimate settlement for their future reporting in that case. …

cross-motions for summary judgment (the government adhering to the IRS' zero-basis approach), the District Court denied both motions and held that "[t]he basis in the life insurance policies 'shall be equitably apportioned among the several parts,'" quoting from the requirement in Treas. Reg. section 1.61-6(a) that applies when only a part of a piece of property is disposed of.[1] In an opinion that thoroughly discussed the open transaction doctrine, the court found that doctrine inapt to the circumstances of a demutualization. Specifically, it noted that under the standard for applying that doctrine articulated by the Supreme Court in *Burnet v. Logan*, 283 U.S. 404 (1931), the open transaction method of taxation is limited to a situation in which the value realized in the sale or exchange is contingent on future events or for some other reason cannot be determined at all at the time of the transaction. Nothing in the demutualization transaction presented such a situation, according to the court, which observed that "there is no question that at the time of demutualization, both the value of the stock and the market value of the policy itself [*i.e.*, on the secondary market] could be calculated."

After rejecting both the zero-basis approach and the use of the open transaction doctrine, the District Court turned attention to the manner in which the trust's basis in the life insurance contracts could be "equitably apportioned" between those contracts and the shares received in the demutualization. The court observed that, generally speaking, there is no single method for apportioning basis when only a part of a piece of property is sold, and it proceeded to summarize the views of several courts of appeals on the question. Concluding that the issue of apportionment was one for the parties to argue at trial, the court called to the parties' attention the case law of the Ninth Circuit Court of Appeals (to which the judgment in *Dorrance* could be appealed), which suggested the use of an apportionment method that compared the original cost of the mutual company contracts to the cost of similar contracts issued by stock companies. The court also called attention to the views of "commenters" on demutualization in particular, which "suggested that comparing the market value of the policy and the stock at the time of demutualization, and applying that ratio to the premium payments, would be more appropriate."

Following an apportionment approach, rather than that championed by the IRS or by the court in *Fisher*, potentially poses an intriguing puzzle for those saddled with filing Forms 1099-R, not to mention the Form 1040, for non-death distributions from life insurance contracts after a demutualization. Since the apportionment approach assumes that the cost of the participation rights subsumed in the shares (or cash) distributed by the demutualized company was paid as part of the premiums for the contracts, it would seem to follow that a reduction in a contract's basis due to such apportionment would translate into a comparable reduction in the section 72(e)(6) "investment in the contract" or "IIC."[2] While it is not always the case that an adjustment to a life insurance contract's basis results in an adjustment to the contract's IIC—the IRS itself recognized a distinction between basis and IIC in Revenue Ruling 2009-13,[3] discussed further below—in this instance it would appear logical, or at least plausible, that a basis reduction due to a portion of premiums being attributed to rights apart from a contract would give rise to a comparable reduction in the contract's IIC.

If so, then parties, including life insurers, who are required to determine taxable gain in reports to the IRS would need to incorporate the amount of that basis reduction into the IIC in their tax information systems. The IIC, after all, needs to be known in order to determine when amounts withdrawn from a life insurance contract that is not a modified endowment contract ("MEC") under section 7702A begin to be includible in income, and also to determine when amounts withdrawn from a MEC cease to be includible. But insofar as the IIC reduction due to apportionment is determined in an *ad hoc* manner, policyholder by policyholder, in settling arguments with the IRS, there seemingly is no way to administer such an approach systematically. The five insurers involved in *Dorrance* perhaps could incorporate the ultimate settlement for their future reporting in that case, but that result would not necessarily apply to any other policyholders. In contrast, where either the zero basis approach or the open transaction approach is followed, the IIC is not disturbed. The IRS could, perhaps, suggest a safe harbor formula to use, *e.g.*, treating some percentage of the pre-demutualization IIC as allocable to the shares, but if the agency continues to stand by its zero basis view for the shares, any such guidance is unlikely.[4]

Hence, Form 1099-R filers, along with insurers' and financial planners' illustration systems, are left with a conundrum if apportionment is to be used. And it is not just demutualized insurers that are left with this, for any insurer administering contracts issued in a section 1035 exchange makes use of the replaced contract's IIC as the starting point for the IIC of the new contract. To complicate matters further, the IRS main-

tains, per Situation 2 of Revenue Ruling 2009-13, that the basis of a life insurance contract in a sale setting (as opposed to the IIC on a full or partial surrender, addressed in Situation 1 of that ruling) must be reduced by the cost of insurance. Since the issue now left for decision in *Dorrance* is technically the apportionment of basis, not of the IIC, the IRS could argue that it is the shrunken basis—the premiums paid reduced by the cost of insurance—that must be apportioned, thereby leaving in its wake a greater putative reduction in the IIC going forward. If so, then taxpayers and tax reporters perchance could point to the same ruling in contending that basis is basis (Situation 2 of the ruling) whereas IIC is IIC (Situation 1), and the twain shall not meet, thus leaving the IIC undisturbed following a demutualization.

Suffice it to say that the apportionment approach sets up more issues for tax professionals to worry about. And worry may be the only result, for it seems doubtful, absent further instruction from the IRS, that tax reporting systems will be altered to reflect some reduction in the IIC of contracts issued by former mutuals. It also remains to be seen whether other courts, if and when asked, will side with *Fisher, Dorrance,* the IRS, or none of the above.

CALCULATING INVESTMENT IN THE CONTRACT: *BROWN V. COMMISSIONER*

As compared with *Dorrance,* the question asked of the courts in *Brown v. Commissioner,* 693 F.3d 765 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-83 (April 12, 2011), is rather a tame one. Indeed, of greatest interest is why the question continues to be asked at all. In an article published in *Taxing Times* last year, Dan Stringham reviewed some five judicial decisions of recent vintage responding to taxpayers' claims quite similar to the one raised in *Brown,* as well as the Tax Court opinion in *Brown* itself.[5] In each of those prior cases, the taxpayer lost, as did Mr. Brown in the Seventh Circuit Court of Appeals.[6] The common theme throughout the cases is that life insurance contracts collapsed after heavy borrowing, insurers dutifully sent out Form 1099-R's, and the policyholders *cum* taxpayers thereby became aggrieved.

The facts in *Brown,* as laid out by the Seventh Circuit, were fairly straightforward as far as contracts with heavy borrowing are concerned. The policyholder purchased a participating whole life contract with a $100,000 face amount in 1982, paid level premiums of $1,837 annually during the first five years, and took loans under the contract to pay the next 14 years' premiums as they came due. During this time, the dividends under the contract were employed to purchase paid-up additional insurance ("PUAs"). Faced with the fact that the policy loans were then approaching the contract's cash value, the policyholder began paying part (but not all) of the next three years' premiums in cash. The accumulated loans, however, were winning the race, and so in 2004, he directed that the PUAs be surrendered to reduce the debt and also that future dividends be applied to pay premiums as well as to reduce the debt. Unfortunately, these actions were insufficient to preclude the contract's cancellation at the end of 2005 due to borrowing in excess of the then cash value, which was in the $37,000 range.[7] This apparently led to the issuance of a Form 1099-R by the insurer showing a taxable amount exceeding $29,000, followed by a dispute between the policyholder and the IRS, followed by a petition to the Tax Court objecting to an IRS assessment. The IRS also assessed a 20 percent penalty based on a substantial understatement of income on the policyholder's income tax return, which the IRS found unsupported by "substantial authority." The Tax Court disagreed with the policyholder and held in the IRS' favor, sustaining the penalty along with the asserted tax deficiency.

Writing for the Court of Appeals, Judge Posner, an eminent jurist and a respected economic thinker, summarized the real gravamen of the lawsuit as only he could: "Naturally, [the policyholder] is loath to pay any tax in respect of the cancellation, since he received no money from it." The policyholder, after all, had borrowed all of the cash value to pay premiums to keep the contract alive for nearly 25 years. According to the court, the feat of maintaining $100,000 of whole life coverage in force over that extended period actually cost the policyholder, out of pocket, around $8,000—before the IRS made an appearance, that is. The policyholder, however, contended that the IIC for his contract was the sum of the premiums paid over that period—some $44,000—which should not be reduced (as the IRS and the Tax Court had earlier concluded) by either the dividends applied to pay premiums and pay down the accumulated borrowing ($5,000, roughly) or by the PUA surrender proceeds applied to the debt (about $31,000), totaling to nearly $36,000. Judge Posner's summation of the policyholder's motivation in this case very likely applies to the motivation behind all of the predecessor cases, too.

To assess the merits (or not) of the policyholder's contention, the Court of Appeals, like the Tax Court before it, was called on to calculate the IIC. This is not surprising, as courts have been asked to engage in this calculation with some frequency.[8] The policyholder, if correct in his contention, would have sustained a (non-deductible) loss of almost $7,000, *i.e.*, $37,000

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of cash value deemed distributed on contract termination less the $44,000 IIC. The Court of Appeals, however, calculated the IIC very differently: the IIC, said Judge Posner, was $44,000 less the $5,000 in dividends applied to pay down debt (and cover two premiums) and also less the $31,000 in PUA surrender proceeds applied to the debt, for an IIC of only about $8,000. Hence, the $29,000 amount includible in income pursuant to section 72(e), on which the IRS assessed the tax deficiency, was correct in the court's view, *i.e.*, the $37,000 cash value at the time of contract termination less the $8,000 IIC produced a positive difference of $29,000.

While the foregoing would not appear as news to most tax professionals,[9] one exchange of thoughts between the policyholder's advocate and the court is worth noting. The court's opinion recorded that the policyholder claimed the PUA surrender proceeds and dividend payments utilized to reduce the large indebtedness (and pay a couple of years' premiums) should be treated as "dividends … retained by the insurer" within the meaning of section 72(e)(4)(B), and thus should be excluded from income as that rule provides. Accordingly, the argument went, they should have no effect on the IIC, up or down. The court responded that section 72(e)(4)(B) "does not apply to non-annuity life insurance payments," citing to section 72(e)(5)(A)(i) and (C). As a matter of statutory construction, this was correct, assuming that the contract in question was not a MEC; that seems a safe assumption, since the contract was a level premium whole life contract issued in 1982. If the contract were a MEC, or if an annuity had been involved, the (e)(4)(B) rule would have applied as a technical matter with respect to the dividends retained to pay premiums.[10] Further, the PUA surrender proceeds, while originating in dividends applied to purchase the paid-up coverage, clearly represented cash value that contained earnings accretions over time, or in other words, "inside buildup." The recapture of PUAs' cash value to support a base contract does not fall within the (e)(4)(B) rule.[11]

The final matter addressed by the Court of Appeals was the substantial understatement penalty assessed by the IRS. That penalty, equal to 20 percent of the tax deficiency, added over $1,700 to the policyholder's tax bill of approximately $8,500. The penalty could be avoided if the taxpayer's failure to include the income on his return was premised on "substantial authority," and the Treasury regulations list a number of items that can be employed for this purpose, spanning the gamut from statutes to private letter rulings. Unfortunately for the policyholder, none of those items could be cited as supporting the policyholder's litigating position. Despite this, the penalty could still be sidestepped if the policyholder made reasonable efforts to determine his tax liability. The court found this lacking as well: "The taxpayers in this case are an attorney couple who made no effort to research the legal basis for their position, or obtain an opinion from an accountant or lawyer, until the Internal Revenue Service challenged their position." And so the penalty was sustained.

THE SURPRISE TERMINATION: *MOORE V. COMMISSIONER*

The IRS apparently thought that *Moore v. Commissioner*, T.C. Summary Opinion 2012-83, should turn out pretty much the same way as *Brown* and all its predecessors did. But the Tax Court had other ideas, and thereby hangs a tale.

In *Moore*, a policyholder who represented himself in front of the Tax Court purchased a participating, level premium whole life contract with a $20,000 face amount in 1975, simultaneously electing the application of the contract's automatic premium loan provision ("APL") to cover through borrowing any premium payments due but unpaid. The policyholder paid the first few years' premiums in cash but then stopped making payments, apparently believing (as the court found) that the contract eventually would terminate according to its terms. However, since the APL had been elected, the insurer began employing policy loans to pay the future premiums as they came due. And at this stage, the facts become intriguing.

According to the insurer's records as replicated in the Tax Court's opinion, the contract continued on in this fashion for more than 30 years, terminating its status as whole life in 2008 due to accumulated borrowing that exceeded the contract's cash value, and then terminating altogether in 2010 when the contract's extended term insurance coverage expired without value. The contract achieved this life span, *via* APL-based premium payments together with some dividends, even though only $472 in premiums had been paid by the policyholder out of pocket, which was equal to about 18 months of the contractual premium at issue. In other words, $472 in premiums—about a year-and-a-half's worth—had sustained $20,000 in whole life coverage for over a generation. This seems less like the miracle of compound interest than it does the miracle of loaves and fishes. To make matters more interesting for the policyholder, he apparently did not recall the APL election and did not learn of the APL's use to sustain the policy in

force until a letter arrived from the insurer in 2005 informing him of this. Additional letters arrived over the next few years, culminating in a 2008 letter announcing that the contract was in default and was converted to extended term status, with the premium loans being converted to permanent withdrawals.[12] This made the situation much worse for the policyholder, for it presented him with deemed taxable income (according to the insurer's calculation) of nearly $18,000 for the 2008 tax year, and of course did so without any cash distribution. There followed an IRS notice of tax deficiency to the policyholder and the policyholder's petition to the Tax Court, in a proceeding under section 7463 that resulted in a decision that is not appealable to any other court and does not count as precedent.

It appears that the IRS thought it a simple matter to lead the Tax Court through the section 72(e) calculation, comparing the loan payoff of roughly $21,600 in 2008 with the IIC at the time (premiums less dividends) of around $3,700 and thereby establishing that the alleged income of almost $18,000 was in fact correct. What's more, the burden of establishing the facts generally rests with the taxpayer, as the IRS' determinations in a notice of deficiency typically are presumed correct. But that is where the matter turned fatally worse for the IRS, for in certain circumstances, under section 7491(a)(1) and (2), the burden of proof shifts to the IRS. The court found that those circumstances were present in *Moore*, for *inter alia* the policyholder/taxpayer/petitioner introduced credible evidence regarding his life insurance contract's operation and why it should be viewed as having terminated decades before 2008. Given the seeming oddities in the record before the court, based largely on the insurer's records and correspondence, this placed the IRS at a disadvantage.

While the Tax Court agreed that using a life insurance contract's cash value to satisfy policy loans is treated as a distribution to the policyholder, citing the court's own precedents to that effect, the court had serious problems with the supposed facts in the case. In particular, the court took issue with the contention that the contract had been kept alive for over three decades via the APL on a record showing that the premiums due were not timely paid through the automatic borrowing. Rather, based on the court's inspection of the insurer's records, the court concluded that the contract had gone into default by the contract's own terms within the first few years of its existence. The IRS, it appears, offered nothing to counter this: "Respondent's [*i.e.*, the IRS Commissioner's] argument would have us construct a multitude of inferences

in his favor and simultaneously turn a blind eye to several unexplained discrepancies in the record. This we will not do." In other words, albeit less elegant ones, the IRS claims that the contract remained in force for over 30 years based on $472 in unborrowed premiums was not credible. On this basis the court concluded that the policyholder was not liable for the 2008 tax deficiency.

Anyone attempting to decipher the facts in the *Moore* case will indeed encounter unexplained discrepancies, even apart from the mystery of the mostly free whole life contract. The IIC calculation offered as part of the record in the case, for example, showed some $5,000 in dividends that reduced the IIC. That is the sole mention of the dividends, apart from the court's comment that there was no supporting documentation concerning them. If the dividends had been paid out in cash to the policyholder, that would have been a reason to subtract them in determining the IIC. It also would have been a sign to the policyholder that the contract remained in force, but neither the policyholder nor the IRS said anything further about them. Perhaps it is just as well that the opinion in *Moore* cannot be treated as precedent, for if it were, considerable time would hereafter be consumed attempting to comprehend the facts of a truly odd situation.

CONCLUDING THOUGHTS

The decisions in *Dorrance, Brown* and *Moore* represent the latest efforts of the courts to determine taxable gain associated with life insurance contract transactions, requiring the resolution of questions involving the contracts' basis or IIC. The

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District Court's conclusion in *Dorrance* that the premiums paid for contracts issued by former mutual companies need to be apportioned between the post-demutualization contracts and the shares issued (or cash distributed) in the demutualizations has rendered the situation potentially unsettled, for policyholders, insurers and the IRS. The conclusion of the Court of Appeals in *Brown*, on the other hand, served to confirm what many others had said before, although the fact that the issue was raised by the policyholder/taxpayer at all leaves one wondering. And perhaps the greatest wonder of the trilogy is the *Moore* case itself, which found no tax due because of the absence of a contract. It is not unusual to see a case brought to the courts claiming that an insurer wrongly denied the in-force status of a contract, but it is virtually unique to see a court decide, as the Tax Court did, that the insurer's claim that a contract had been in force was itself wrong. ◂

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END NOTES

1 The Court of Federal Claims had also considered the applicability of Treas. Reg. section 1.61-6 in *Fisher,* but concluded that the demutualization facts presented were "one of the 'rare and extraordinary' situations in which the 'open transaction' exception to Treas. Reg. § 1.61-6 should apply."

2 Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

3 2009-21 I.R.B. 1029. This ruling is discussed in Frederic J. Gelfond and Yvonne S. Fujimoto, *Recent Guidance Involving the Taxation of Life Settlement Transactions,* 5 *Taxing Times* 27 (Sept. 2009).

4 Although the IRS has not publicly announced any intention to abandon its "zero basis" litigation position, a recent development in another demutualization case suggests some potential movement on the issue. In *Cadrecha v. United States*, 109 A.F.T.R. 2d 2012-1664 (2012), the taxpayer sold stock that he had obtained when the issuer of his life insurance contract demutualized. He paid tax on the sale as if he had no basis in the stock, but subsequently learned of *Fisher*, which was then-pending in the Court of Federal Claims. Thus encouraged, he filed an amended return in the hopes of protecting a claim for refund pending the outcome in *Fisher*. After an extensive series of letters and conversations between the taxpayer (or his accountant) and the IRS, during which time the Court of Federal Claims decided *Fisher* against the government, the IRS denied Mr. Cadrecha's claim on the grounds that the statute of limitations had run. He then filed suit in the Court of Federal Claims, *i.e.*, the *Fisher* court. The court, however, agreed with the statute of limitations point and ruled against the taxpayer, even though it saw the result as "harsh" in light of the record. The taxpayer, too, saw harshness in the result and filed an appeal with the U.S. Court of Appeals for the Federal Circuit. Then things got interesting. Before the government filed its brief in the appeal, it settled with the taxpayer. The government's motion to the court describing the settlement said that the Department of Justice had conferred with the IRS Chief Counsel regarding the government's position in the case, and that following the consultation the government's lawyers approached the taxpayer's lawyer to discuss a potential settlement.
A deal was struck where the IRS would refund a portion of the income tax payment in question and the taxpayer would agree to dismiss his appeal. This eliminated the possibility that the government might lose the procedural issue on appeal and thus be faced with defending the same substantive arguments that the Court of Federal Claims had already shot down in *Fisher*. Of course, the motion describing the settlement makes no mention of how, if at all, it might affect the taxpayer's IIC with respect to the life insurance contract from which all these issues sprang in the first place.

5 Daniel Stringham, *After Going 0 for 6 in the United States Tax Court, Will Taxpayers Finally Give Up the Fight?* 7 *Taxing Times* 39 (Sept. 2011).

6 Since Dan Stringham's article and the Court of Appeals decision in *Brown*, yet another case on this subject made its way through the Tax Court, with the taxpayer once again coming out on the losing end. *See* White v. Commissioner, T.C. Summary Opinion 2012-108 (Oct. 31, 2012). So, the answer to the question that Dan posed in the title of his article is, apparently, "no."

7 Note that this and the following numbers in this article are approximate due to (1) the ease of reading and comprehending them and (2) the fact that the authors are lawyers, not actuaries.

8 *See, e.g.*, Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964); Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960), *rev'g* 30 T.C. 866 (1958); London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935).

9 The details of the IIC calculation are as follows. The owner paid premiums of $12,000 in cash. He paid another $28,000 using the proceeds from policy loans. This was just as if the owner had borrowed the money from a bank and used that cash to pay the premiums. Lastly, he paid $4,000 by instructing the insurer to retain dividends as premium payments (see note 10, *infra,* for more on these dividends). This all sums to $44,000, which is the aggregate amount of premiums paid for the contract within the meaning of section 72(e)(6)(A). In order to determine the IIC, section 72(e)(6)(B) requires that the foregoing sum be reduced by any excludable amounts received under the contract. The owner received a total

of $36,000 in such excludable amounts, which reduced his IIC from $44,000 to $8,000. Specifically, he surrendered PUAs that reduced the contract's cash value by $31,000. Even though the insurer retained that amount to pay down policy loans, it was still a distribution of cash value, just as if he had borrowed from a bank and surrendered the PUAs to pay the bank loan. And because the contract was a non-MEC, the PUA distribution was excludable to the extent of the IIC (*i.e.*, the section 72(e)(2)(B) "income-first" ordering rule did not apply). In addition, the owner instructed the insurer to use $1,000 in dividends to pay down policy loans. This, too, resulted in a distribution from the contract, which was excludable from gross income for the same reason as the surrendered PUAs. Finally, the owner received the $4,000 in dividends, described above, that the insurer retained to pay premiums under the contract. This, too, resulted in a deemed distribution from a non-MEC that was excludable to the extent of the IIC. Note, however, that the treatment of these dividends effectively results in a "wash" in determining the IIC; they are subtracted from the IIC when deemed distributed, then added back to the IIC when paid into the contract as new premium.

[10] One can hardly blame the taxpayer for arguing that section 72(e)(4)(B) applied, at least to the dividends that the insurer retained to pay premiums. After all, that section specifically refers to dividends retained for such purpose. However, (e)(4)(B) says only that such dividends are not included in gross income under the income-first ordering rule of section 72(e)(2)(B). Thus, if a contract—like a non-MEC—is not subject to the income-first rule at all, the (e)(4)(B) rule has no relevance, which the court observed. Nonetheless, the result is largely the same for the $4,000 of dividends retained to pay premiums when you view them as deemed distributions from a non-MEC, because they will be excludable to the extent of the IIC.

[11] *See, e.g.*, H.R. Rep. No. 100-1104, Vol. 2, at 102 (Conf. Rep.) (1988) (discussing the distribution rules applicable to modified endowment contracts).

[12] For the most recent 12 years, the taxpayer lived at the same address and received mail from the insurance company there. The court noted, however, that the taxpayer "generally believed that this mail was marketing materials."

WHAT DOES "PREVAILING INTERPRETATION OF THE STATES" MEAN?

By Edward Robbins

In the October 2012 issue of *Taxing Times,* Peter Winslow wrote an article titled, "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."

While the Winslow article was excellent, this article expands somewhat on one item that article discussed: TAM 200448046. The Internal Revenue Service (IRS) had taken a position in the *American Financial* case with respect to how actuarial guidelines should be considered, relative to other guidance.

The Winslow article states: "In TAM 200448046 (30 August 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 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.[1]"

Contrary to what is implied above, the TAM was likely correct in its conclusion denying the use of the Connecticut approach, even though, as discussed in the Winslow article, the reasoning utilized was not appropriate. While there is a requirement in the Internal Revenue Code (the Code) to pick the mortality assumption that results in the lowest reserve among the explicit NAIC-based mortality options available [Section 807(d)(5)(e)], there is no need to choose the "method" that results in the lowest reserve. Indeed, where there is an explicit choice of method given in the NAIC guidance, the taxpayer can choose among them, the only requirement being that the tax-basis method must follow the statutory-basis method. The TAM implied that the company must adopt the method that yielded the smallest reserve permitted by 26 states, and it took the position that the Connecticut requirement was not the "prevailing interpretation of the states." The TAM apparently took the term "interpretation" to include passive acceptance[2] by a state of a reserve methodology. Further, the TAM cited an excerpt from the 1984 Tax Act legislative history: *"The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more, unless the net surrender value is greater."* It is questionable whether such an "intent" would be controlling, given that Code section 807(d) does not mention this concept in the reserve calculation requirements. Indeed, the courts apply the language of the Code rather than the legislative history when the Code is clear.

Further, there are two elements of guidance in particular that pertain when the NAIC has not defined the tax reserve "method" for a contract or benefit, inasmuch as, in the instant case, there was no NAIC guidance for the guaranteed minimum death benefit (GMDB, sometimes referred to as MGDB) reserve at the time of promulgation of the Connecticut requirement.

First, Code section 807(d)(3)(A)(iv)(II) stipulates the following:

> *If no reserve method has been prescribed by the [NAIC] which covers such contact, a reserve method which is consistent with the reserve method required under clause (i), (ii), or (iii) or under subclause (I) of this clause as of the date of the issuance of such contract (whichever is most appropriate).*

For the instant case, we will refer to the above as the "consistent with CARVM" requirement.

Second, the 1984 Tax Act legislative history contains the following language:

> *If specific factors are not prescribed by the NAIC recommended reserve method, the* ***prevailing state interpretation*** *of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes.*[3] *[Emphasis added.]*
>
> This begs the question of what a prevailing state interpretation is. There has been general agreement that the word "prevailing" means agreement among at least 26 states. The meaning of the word "interpretation" is less clear. Should it include a state administrative act, such as a letter from a state insurance department to one company only, or would it have to be a public announcement (circular letter, regulation, etc.)? The former might be correct, but administratively impossible to research. The latter would be the more pragmatic approach to such a definition. If one subscribes to the position that passive acceptance by a state does not constitute a "state interpretation," then it appears that there was no prevailing interpretation of the GMDB reserve method requirement prior to AG34. (See references at the end of this article.)

The TAM indicates that the fact that many states *permitted* the Connecticut requirement (which, the TAM stipulates, was a higher reserve requirement than any other state requirement at the time) was not a compelling reason to validate the Connecticut requirement for federally prescribed tax reserve purposes. Indeed, speaking in general terms, statutory regulatory policy at most *requires* a minimum reserve standard and *permits* a method that yields a higher reserve. The TAM was likely correct in rejecting the Connecticut method, but the approach taken should have been that the Connecticut method was not incontrovertibly a method "consistent with CARVM," especially in light of the fact that, as the TAM stated, it was an unusually onerous requirement. The IRS should have challenged the taxpayer to support a "consistency with CARVM" position. However, that may have been difficult for the taxpayer to support, in part since, according to our understanding, the reserve requirement included an immediate one-third drop assumption on the account value, ***including any elements of the account values invested in the general account.***

There has been general agreement that the word "prevailing" means agreement among at least 26 states.

The "consistent with CARVM" requirement can be read in two ways. The narrow reading is that this section would apply when a contract is not covered by CRVM/CARVM. A broader reading, as suggested by the Committee reports, is that this section applies when CRVM or CARVM is not defined by the NAIC for a particular contract or benefit. The fact pattern under this TAM fits the latter interpretation, as CARVM had not been defined for GMDBs at that time.

The issue then is, "When one state alone requires a very high statutory reserve for a contract or benefit for which the NAIC has not prescribed a method, does this give a company the right to hold a tax reserve on that very high method?" It would seem that an affirmative conclusion would open the floodgates for companies with substantial surplus that would like to reduce taxable income. There are numerous instances in which one state's unusually high requirement does not necessarily become the applicable tax reserve. Failing a "prevailing interpretation," the "consistent with CARVM" requirement should have been invoked by the IRS. This would have correctly placed on the company the burden of demonstrating that this requirement had been met.

So much for the case in which a reserve method has not been defined. The next question is, "How far does the *American Financial* decision go in providing guidance where there are 'two or more permitted methods'?"

One logical criterion is whether a method is permitted *by NAIC prescription.* According to the language of the Court

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of Appeals decision, it is neither individual states nor the IRS, but the NAIC that defines the permitted methods. For example, there are several NAIC pronouncements that speak to continuous versus curtate functions on life insurance.[4] Moreover, when there are multiple explicit options prescribed in an NAIC actuarial guideline, such as in Actuarial Guideline XXXV,[5] there is no question that the company has a choice of method, as long as the tax basis method is consistent with the statutory method.

In sum, it goes too far as to say that whatever a state "permits" should, in and of itself, provide sufficient grounds for tax reserve purposes. In the absence of NAIC guidance, if a particular method is supportable as a method "consistent with CARVM," and there is no prevailing state interpretation, then there would be sufficient support for such "consistent" tax reserve calculations. In the case of an existing prevailing state interpretation, it appears that the "consistent with CARVM" approach might still apply, although the burden of proof then would be on the IRS to take the position that the prevailing state interpretation is not consistent with CARVM.

In the case of both regulatory requirements and company practice in reserving for MGDBs prior to the advent of AG34, some history does exist which to some extent contradicts the fact pattern expressed in TAM 200448046. The only data that we found readily available with respect to MGDB reserving practice pre-AG34 is an excerpt from Mr. Stephen Preston, FSA, at the Society of Actuaries 1997 Montreal Spring Meeting. He stated:

> *The SOA MGDB survey is somewhat dated, so I won't dwell on it, but in 1995 the Task Force completed a survey of MGDB and I think it is still basically up to date. The survey identified various types of MGDBs, contract charges, reinsurance, and methods used to quantify MGDB risk. The SOA Task Force also identified variable annuity reserving practices for the base contract, ignoring any MGDB. Most of the companies that were surveyed used some type of CARVM approach based on a projection of the account value, based on the valuation rate less some combination of asset charges. As far as current reserving practices on MGDB, there were two approaches commonly used. First, the prospective method is typically a one-year term reserve, typically with a drop in account value assumed. Second, some companies use a retrospective approach, similar to the one required by New York, where you put a target amount into a fund and remove claims as they're incurred.*

In that session, Preston also spoke to the state of MGDB reserve regulation pre-AG34 as follows:

> *In the absence of specific NAIC regulations governing MGDBs, some states have tried to apply the NAIC* Variable Life Model Regulation*. There are two variations of this Model. The variation most commonly used requires a one-year term reserve with a one-third drop in account value, with life insurance valuation interest and mortality. Additionally, the Connecticut Circular latter requires companies to apply their* Variable Life Regulation *to variable annuity MGDBs. It uses an approach similar to the NAIC Variable Life Model Regulation. It also requires mirror reserving. New York Regulation 47 provides different requirements, depending on whether the MGDB is incidental or not. New York defines incidental as return to premium or account value, and possibly ratchet MGDBs. For incidental death benefits, New York permits an accumulation type of reserve where a reasonable target is determined, and then the target is placed into a fund, less claims. For non-incidental MGDBs, New York requires compliance with their* Variable Life Model Regulation*, which requires a method similar to the NAIC V*ariable Life Model Regulation*. Also many companies have begun to use the requirements in drafts of Actuarial Guideline MMM, and many regulators have been accepting those requirements.*

This language suggests that there was no prevailing interpretation of the states in the CARVM requirement for MGDBs if one eliminates a state's passive acceptance of a reserve method as a "state interpretation." Thus, premised on the lack of a prevailing state interpretation, the TAM could have invoked the "consistent with CARVM" requirement if it chose to deny the Connecticut method. This would have placed on the company the burden of demonstrating that that criterion had been met. ◂

END NOTES

[1] 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 (September 2005).

[2] "Passive acceptance" is herein defined as a state taking no action with respect to a company's filing of a statutory annual statement. To hold that such passive acceptance constitutes a state "interpretation" leads in part to the anomaly that annual statement filings can consist of many different reserve approaches among companies. If a state passively accepts all of them, this renders the term "interpretation" difficult if not meaningless. Indeed, the IRS would never extend the concept of passive acceptance to its audits of taxpayers.

[3] 1984 Act Senate Committee Reports, CCH page 951; see also Blue Book page 601.

[4] This was true to some extent even prior to Actuarial Guideline XXXII, which prohibited the use of curtate functions without an Immediate Payment of Claims adjustment.

[5] The Application of the Commissioners Annuity Reserve Method to Equity Indexed Annuities.

AUTHOR'S RESPONSE TO ROBBINS' ARTICLE

By Peter H. Winslow

Ed Robbins' analysis of TAM 200448046 helpfully advances the discussion of when statutory reserves are an acceptable basis for tax reserves. Although I generally agree with the thrust of Robbins' comments, several additional comments may be useful.

First, as a technical matter, I do not believe TAM 200448046 implicates the "consistent with CARVM" requirement of I.R.C. § 807(d)(3)(A)(iv)(II). Actuarial Guideline 33 made it clear that all benefits provided in an annuity contract must be considered in the CARVM reserve, including guaranteed minimum death benefits. Therefore, TAM 200448046 presents a case where the National Association of Insurance Commissioners' (NAIC's) general requirements of CARVM actually apply and there is no need to resort to the "consistent with CARVM" provision of I.R.C. § 807(d). Having said that, I generally agree with how Robbins frames the issue. The validity of the Connecticut reserve method for tax purposes turns on a determination as to whether the one-third drop assumption is a permissible interpretation of CARVM at the time the contracts were issued or, instead, whether the drop assumption is so onerous that it goes beyond a reasonable interpretation of CARVM. In court the burden of proof to establish that the one-third drop assumption was permissible would be on the company.

Robbins' article suggests that the TAM's conclusion could be correct apparently because the Connecticut requirement to apply the one-third drop assumption to elements of the account values invested in the general account is inconsistent with CARVM. Let's assume that Robbins' article is correct on this point (a debatable point). That does not mean that TAM 200448046's conclusion was correct. The proper approach should have been to start with the company's statutory reserves and adjust any factors that are not a permissible interpretation of CARVM. If the problem is the application of the one-third drop assumption to the general account assets, then tax reserves should be computed by using the Connecticut method, including the one-third drop assumption for separate account assets only, thereby adjusting the reserves to eliminate the factor that was an unreasonable (not permissible) interpretation of CARVM. In summary, I continue to believe that the tax reserves computed using the Connecticut method should have been allowed, possibly as adjusted, and the TAM was wrong to conclude otherwise.

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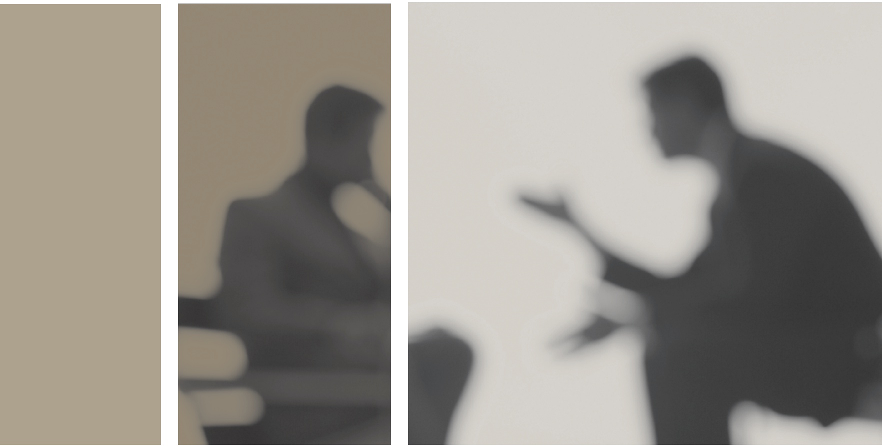

ACTUARY/TAX ATTORNEY DIALOGUE ON SELECTED TAX ISSUES IN PRINCIPLE-BASED RESERVES (PART IV)

By Christian DesRochers, Mark S. Smith and Peter H. Winslow

Editor's Note: *Since the May 2006 issue of* TAXING TIMES*, we have dedicated nearly 50 pages of content to the broad topic of principle-based reserves (PBR) and related issues, including five articles,[1] 1 three dialogues,[2] two tidbits[3] and one letter to the editor.[4] On Dec. 2, 2012, the National Association of Insurance Commissioners (NAIC) adopted the revised Valuation Manual that sets forth principle-based reserving (PBR) requirements for life insurance and annuities. The vote allows the Standard Valuation Law (and the accompanying Valuation Manual) to be sent to state legislatures for adoption. As the implementation of PBR is moving closer, we present yet another actuary/attorney dialogue on PBR to revisit federal-income-tax-related issues in the context of what we have learned since we began the discussions nearly seven years ago. In the prior dialogues, we discussed a number of tax reserve issues, including whether PBR constitute insurance reserves under Section 816(b) of the Internal Revenue Code, whether they qualify as CRVM or CARVM reserves, as applicable, under Section 807(d) in whole or in part, and, if so, how PBR should be recomputed for tax purposes.*

I am joined in the discussion by two individuals who are familiar to readers of TAXING TIMES*, Peter Winslow of Scribner, Hall & Thompson, LLP and Mark Smith of PricewaterhouseCoopers, LLP. As always, the views that we express are our own.*

Chris: As we begin the conversation, I'd like to ask Peter what has changed with respect to PBR since we last discussed the issue.

Peter: Since Part III of our PBR dialogue published in the March 2008 edition of *TAXING TIMES,* there have been several significant developments. These developments can be grouped into four general categories. First, the Internal Revenue Service (IRS) and Treasury have provided guidance in the form of two notices: Notice 2008-18[5] dealing with PBR generally and Notice 2010-29,[6] addressing the transition to Actuarial Guideline 43 (AG 43), which represents a principle-based approach to variable annuity guaranteed benefits. Second, several court cases have been decided that are relevant to our discussion, including the *American Financial*[7] and *CIGNA*[8] cases. And, I would even add a recent property/casualty tax case, *State Farm*[9] to the list of relevant cases, and I will explain why later. Third, there have been changes to PBR itself including the Net Premium Reserve Floor and a three-year transition rule. The fourth category I will label as "outside influences" that could have a direct or indirect impact on PBR itself and/or the tax treatment of PBR. I would put into this category the possibility of adoption of International Financial Reporting Standards (IFRS), or a revised insurance contract standard for GAAP, as well as the possibility of comprehensive corporate tax reform.

Let's take these topics one at a time. Mark, could you start with the IRS' guidance in Notice 2008-18 and 2010-29 and bring us up to date as to how the IRS' analysis in those notices could apply to PBR?

Mark: Well, Peter, my sense is that Notices 2008-18 and 2010-29 together give the IRS and Treasury a tremendous head start in guidance on PBR. For example, the fundamental issues that Notice 2008-18 identified in connection with Life PBR remain the most important issues on the IRS and Treasury agenda for addressing tax issues that PBR raises. The industry comments in response to that notice are as helpful in 2013 as they were in 2008. Also, the similarities between the Standard Scenario Amount (SSA) of AG 43 and the Net Premium Reserve Floor of VM-20 suggest a path forward for PBR that would require little additional work, should the IRS and Treasury decide to begin their work starting with the same template.

The larger concern, I think, is not the treatment of the SSA or Net Premium Reserve Floor, but rather unanswered questions about other elements of tax reserves. What is the treatment of the CTE Amount of AG 43? What about the Stochastic Reserve or Deterministic Reserve of VM-20? Why has the IRS to date not confirmed that the statutory reserve cap is simply the amount of a company's statutory reserves? These are industry-wide issues that should be addressed prospectively, rather than the subject of after-the-fact challenge in exam or

litigation. I would like to believe that the work that went into Notices 2008-18 and 2010-29 frees up the IRS and Treasury to tackle a broader range of issues in the context of PBR and pick up where work left off on AG 43 in 2010.

Chris, can you share a little bit about how Notice 2010-29 was received from the perspective of an actuary? What worked well, and what didn't work well?

Chris: Notice 2010-29 and AG 43 are a good starting point, as together the IRS, Treasury and the life insurance industry are gaining some practical experience dealing with PBR in the context of variable annuity reserves. However, there are also some differences between AG 43 and Life PBR under VM-20, including the fact that AG 43 was retroactive to 1981 issues while Life PBR is prospective for issues after its effective date. Overall, I believe that positive results have been achieved through Notice 2010-29. One of the most important is the belief that while the emerging reserve methods may make it more difficult to fit the "square peg" of PBR into the "round hole" of Section 807, there is a commitment on the part of Treasury and the IRS to work with the industry to keep life insurance companies in Part I of Subchapter L of the Code; that is, to keep life insurance companies taxed as such, and not as property/casualty companies under Part II. However, in the long run, the approach used in Notice 2010-29 of bifurcating the statutory reserve into a deductible tax reserve segment and a non-deductible reserve segment based on the actuarial computation method applied to each segment may prove to be problematic.

Peter: I agree with you that it is problematic for the IRS. It will be difficult for the IRS to have it both ways and say, on the one hand, that PBR qualify as life insurance reserves for purposes of the life insurance company test under Section 816, and, on the other hand, argue that they are not life insurance reserves for deduction purposes under Section 807. Yet, if the IRS takes a different approach and says that PBR are not life insurance reserves for any purpose, then the door would be open for tax planning on the company status issue by choosing to hold, or not to hold, principle-based statutory reserves.

Mark: For what it's worth, I don't believe the IRS would on the one hand rely on the cross-reference to life insurance reserves under Section 816(b) to exclude reserves from section 807, and on the other hand claim that the definition of life insurance reserves is different for purposes of the two provisions. Notice 2008-18 included an assurance that the IRS and Treasury did not think it would be appropriate to treat PBR in a way that summarily converted life insurance companies to non-life insurance companies for tax purposes. And, even Notice 2010-29 included at least the SSA in life insurance reserves.

I don't think the IRS has been very focused on life insurance company status at all for one practical reason: many assume that so far under AG 43 the treatment of the CTE Amount is not material enough to change a company's status. Likewise for PBR, assuming the Net Premium Reserve, at a minimum, is treated as a life insurance reserve, how many companies would find their status at risk? Some companies may hover close to the line. I know there was tension around life insurance company status for a handful of companies 10 or 15 years ago, driven by differences between life and non-life proration, an issue that has occupied nearly as many pages in *Taxing Times* as PBR has.

Chris: One objective of Congress in enacting the 1984 Act concept of "federally prescribed reserves" was to allow life insurance companies to deduct reserves appropriate to the risks under their contracts but not allow a deduction for voluntary reserves that an insurer may choose to hold. If the goal of PBR is to develop a definition of reserves that reflects the economic cost to the insurer of the benefits to be provided, it can be argued that PBR in their entirety are the appropriate measure of the liabilities, consistent with the intent of Congress in 1984. Thus, the separation of reserves into segments to determine deductibility, while an expedient to identify that part of the reserves that clearly fits the formulaic model under Section 807, also represents an artificial allocation of the potential cost of the liability with respect to the determination of a life insurer's taxable income. This can create situations where significant non-deductible reserves emerge, which are not consistent with the underlying economic cost of the liability being reserved for.

To address the specific question, Notice 2010-29 was helpful to the industry by providing guidance on the transition to AG 43. At the same time, by limiting tax reserves to the SSA, Notice 2010-29 creates potentially unresolved issues for the industry, the IRS and Treasury. For example, the limitation on deductible reserves for 2010 and later issues creates a situation where a significant portion of the reserves required under AG 43 may not be deductible, where the statutory reserves

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include a significant stochastic element while the tax reserve is limited to the SSA.

Peter, another feature under AG 43 is that it applies retroactively to statutory reserves, but not necessarily for tax. Can you talk about how companies are handling that aspect of AG 43?

Peter: Companies generally are taking one of two approaches. Because Section 807(d) defers to the National Association of Insurance Commissioners' (NAIC's) prescribed tax reserve method at the time the contract was issued, some companies are using AG 39 (and AG 34 for guaranteed minimum death benefits) for pre-2010 contracts. Other companies are using some version of what is now being referred to as the "hybrid method," that Mike LeBoeuf and I outlined in our article in the May 2011 edition of *Taxing Times*.[10] These companies do not use AG 39 because it always was scheduled to sunset at the time the contracts were issued. I think both of these groups of companies include the CTE Amount in statutory reserves for purposes of the statutory reserves cap. Needless to say, the IRS should address this issue to determine which group has adopted the correct position. Who knows? Maybe the IRS will permit either tax reserve method to be used to avoid audit disputes.

I do not know of any companies that are applying AG 43 retroactively to pre-2010 contracts. Mark, is this now a viable position in light of the *American Financial* case and should companies reconsider whether AG 43 should have retroactive effect for tax purposes?

Mark: Well, I think the term "retroactivity" itself prejudices the conversation in a way that's not helpful. We're not talking about changing or restating reserves for prior years. The issue is what reserve methodology applies in future years, for previously issued contracts. In this regard, I think the primary lesson of *American Financial* is that there is no hard-and-fast rule for all new AGs. Rather, each AG will need to be evaluated to determine the extent to which it represents a change to previous actuarial guidance, versus a clarification or refinement.

The application of AG 43 to previously issued contracts would present unique issues: Although some features of AG 43 already were familiar before 2010, others are quite different from prior guidance. A taxpayer that already adopted AG 43 in 2010 based on Notice 2010-29 could lose the protection of that notice as a safe harbor for taxable years in which AG 43 is applied with respect to pre-2010 contracts. The IRS would likely challenge such a move. Companies may differ in terms of the impact of AG 43 on their block of business, or their intended treatment of the CTE Amount. There may be circumstances where a conversation about retroactivity could be had, but where that conversation would lead is uncertain. I do not anticipate a wholesale move to apply AG 43 to previously issued contracts.

Your comment about the IRS permitting either AG 39 or the "hybrid" method for pre-AG 43 years could be prescient, though. There may be other methods as well. I think in the long term, it is inevitable that the IRS and Treasury will need to acknowledge that in some cases, there can be more than one permissible reserve methodology. Since NAIC has at different points in time endorsed both AG 39 and individual elements of the hybrid method, it may be too late for the IRS to come in after the fact and declare that one, but not the other, was permissible for contracts issued before 2010.

Chris: In dealing with the issue of pre-2010 contracts, AG 39 may be unique among actuarial guidelines, as it was designed to be temporary from inception, although that fact does not extend to Actuarial Guideline 34 (related to minimum death

benefit reserves), which AG 43 also replaced for statutory reserves. However, the current situation raises an audit issue for the IRS, and that is: what methods are acceptable for pre-2010 contracts? At some point, some guidance may be needed as to what is acceptable and what is not, or the issue may simply be left to audit. It is a transitional issue, as it applies to a closed block of contracts, but it will be around for several years. Now I'd like to turn the conversation to Life PBR which is looming on the horizon. Before we do that, earlier Peter mentioned the *State Farm* case, which did not even involve a life insurance company. How is that relevant?

Peter: In my opinion, the *State Farm* case just underscores an important lesson already gleaned from *American Financial*—when the Internal Revenue Code defers to the NAIC, there is no room in the statute for the IRS to second-guess the NAIC and select its own tax reserve method.

The *State Farm* case dealt with a property/casualty company that included extra-contractual obligations (ECOs) in its deductible claim reserves. This treatment was consistent with clear NAIC guidance. As in the case of the tax reserve method for life companies, the Internal Revenue Code, Sections 832 and 846, defers to the NAIC's method of accounting for property/casualty claim reserves. The IRS argued that ECOs were not claims "on insurance contracts" and, therefore, the NAIC's accounting guidance was inapplicable. The Seventh Circuit disagreed, noting Congress' direction in the Code that NAIC accounting governs for underwriting income. So, in giving guidance under PBR, the IRS must pay close attention to what the NAIC has done—and defer to it.

Mark: Peter, do you think it matters that the *State Farm* case involved the nature of risks that are appropriately included in reserves (that is, ECOs), whereas the instruction in Section 807(d)(2) is to use CARVM or CRVM, *i.e.*, the methodology for accounting for those risks?

Peter: Not really. For property/casualty companies, the Internal Revenue Code defers to the NAIC to determine the accounting for underwriting income. So, in effect, the court in *State Farm* held that the deference to the NAIC could include what is included in underwriting income—in that case ECOs. In the case of life insurance reserves, the Code defers to the NAIC for the tax reserve method. Although this could be considered narrower deference, I believe that deference should include, for example, tax recognition for NAIC-prescribed CRVM reserves that are computed using a gross premium or stochastic method.

Chris: Peter, does the *American Financial* case have any other possible impacts on PBR?

Peter: I believe that there are two fundamental principles in *American Financial*. The first is what we have been discussing—the court made clear that the Code defers to the NAIC, not the IRS, to interpret the tax reserve method—in this case CRVM. The second principle is that, under the NAIC method, there can be more than one permissible interpretation at the time the contract is issued. And, if the company changes its statutory reserves from one permissible method to another, there is nothing that precludes the company from making a conforming change to tax reserves.

The second principle from *American Financial* I just mentioned is directly relevant to PBR's three-year transition rule. During a three-year period after VM-20 is adopted by the NAIC, companies will be able to choose whether to stay on old CRVM or to adopt PBR. Because VM-20 will say that either method is a permissible interpretation of CRVM during the transition period, whichever choice is made for statutory reserves also should apply for tax purposes.

Even though there are major tax issues to be resolved under PBR, it is interesting to note that the adoption of VM-20 should resolve at least one of the central disputes in *American Financial* as it relates to contracts for which PBR reserves will be held. The primary cause of the *American Financial* litigation was a basic disagreement about what tax reserve method to use when a company adopts a new statutory reserve method that was permissible, but not required, when the contract was issued. Companies, including American Financial, argued that they were entitled to conform their tax reserves to the new previously permissible statutory method. The IRS responded that the companies were required to search for the method that would yield the lowest reserve permitted by 26 states. This issue arose because the Standard Valuation Law's definition of CARVM (or CRVM) did not change—it was only the NAIC's or states' interpretation of the Standard Valuation Law that had changed.

This issue will go away once PBR is adopted. The Standard Valuation Law will cross-reference to the Valuation Manual, and state law will incorporate the manual. This means that if

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the method described in the manual changes, then both the CRVM and the 26-state interpretation will automatically change along with it. So, we should have no more disputes about whether a new actuarial guideline or 26-state prevailing view should govern for changes in the CRVM.

Chris: One thing we discussed earlier related to AG 43 and Notice 2010-29 is the concept that the deductible reserve is made up of a portion of the total reserve that fits within the definition of "reserves" as it is found in Section 816 as well as meeting the requirements of Section 807 for computing federally prescribed reserves. Under VM-20, the minimum reserve for life insurance policies subject to PBR is based on three elements, depending on the policy: an aggregate net premium reserve plus deterministic and stochastic reserve elements, if applicable to the policy. We know that the "net premium floor" was important to identify at least a portion of Life PBR that would unquestionably satisfy the Internal Revenue Code's reserve criteria. However, are we once again falling into the "trap" of bifurcating the statutory reserve as an expedient to meet the Code's requirements? Peter, is Life PBR CRVM and how far did Congress go in allowing the NAIC to set the tax reserve method under Section 807?

Peter: The decisions of the Sixth and Seventh Circuits that I just mentioned call into question whether the IRS could successfully limit the federally prescribed reserves for PBR to the Net Premium Reserve Floor. If the NAIC decides that PBR in its entirety is CRVM and is the minimum amount necessary to provide for future benefits under the contract, it is questionable whether the IRS has the ability to say that only a net premium method qualifies for tax purposes. Similarly, the fact that PBR takes into account all cash flows, including expenses, may not matter. As in *State Farm*, it is for the NAIC to determine how tax reserves should be computed and factors outside the contract can appropriately be considered.

I understand that the IRS is considering taking the position that the deterministic and stochastic portions of PBR are not part of the federally prescribed tax reserves because they do not qualify as life insurance reserves under Section 816(b). But, I believe that this potential position is a dead end for two reasons. First, and most importantly, as I have said in prior dialogues, I think that PBR in its entirety will satisfy every criteria of the definition of life insurance reserves. I find this whole argument that only a net premium reserve will qualify as a life insurance reserve, or deductible reserve, troubling. To me, the argument boils down to: Congress did not intend to permit tax reserves to evolve to reflect life insurance liabilities more accurately. It seems strange to presume that Congress made a tax policy decision to preserve outdated tax reserves. Fortunately, Congress did just the opposite by deferring to the NAIC's tax reserve method, whatever that is, at the time the contract is issued.

The second reason this Section 816(b) argument is a dead end is that the legislative history is pretty clear that, regardless of whether statutory reserves satisfy Section 816(b), tax reserves still must be computed under Section 807(d). That Code section defers to the NAIC.

Mark: Well, it is fortunate that VM-20 includes a net premium reserve floor. I don't think anyone from the IRS or Treasury could reasonably believe that anything less than that amount should be allowed for life insurance contracts subject to VM-20. It might be easiest for them to limit federally prescribed reserves to the net premium reserve with little further thought, but that would be a mistake. Given the still-unanswered questions from Notice 2008-18, lessons learned on AG 43 since Notice 2010-29, the *American Financial* and *State Farm* cases, and development of a more robust regime for Life PBR in VM-20, I think the IRS still needs to address some fundamental issues head-on before moving forward. One such issue is, as you point out, the legislative history that says that the cross-reference to the definition of life insurance reserve under Section 816(b) is meant only to identify the "types" of reserves for which increases and decreases are taken into account. I don't believe that cross-reference superimposes a second computational limitation on life insurance reserves in addition to the rules of Section 807(d)(2).

Peter: So, do you agree that if the IRS appropriately defers to VM-20, and overcomes its historic objection to a gross premium reserve methodology, the deterministic reserve and stochastic reserve are automatically included in both the federally prescribed reserve and the statutory cap?

Mark: Yes, but. For the statutory reserve cap, the issue is pretty simple. The Internal Revenue Code asks only what is the aggregate amount set forth in the annual statement with respect to enumerated items, including life insurance reserves. Statutory reserves equal statutory reserves, or stat equals stat. This is why including the CTE Amount of AG 43 in the statutory reserve cap should not be controversial. It is also why (in addition to legislative history directly on point) the priority guidance plan project on deficiency reserves should be easy to answer.

For the federally prescribed reserve, though, logistical issues are still unanswered (at least with regard to stochastic reserves). Part of the reason for excluding the CTE Amount from the federally prescribed reserve in Notice 2010-29 was the inconsistency between the formulaic approach of Section 807(d)(2)—including the use of a single prescribed interest rate contract-by-contract—and the stochastic approach used to determine the CTE Amount. Likewise, if the stochastic reserve of VM-20 were to be included in the federally prescribed reserve, would a methodology be needed to compute that reserve using the greater of the applicable federal interest rate (AFIR) or the prevailing state assumed rate? Or would the comparison at that point become meaningless?

Peter: I agree. As I keep repeating, I think the correct answer is that PBR in its entirety should qualify both as life insurance reserves and as CRVM reserves deductible as the federally prescribed reserves. Having said that, I still do not know exactly how we are supposed to recompute the stochastic reserve component under Section 807(d). For example, what do we do with the requirement to use the greater of the AFIR or prevailing state assumed rate? Chris, Is there an actuarial way to solve this conundrum?

Chris: Section 816 codified the long-standing requirement that reserves "are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest." Broadly defined, Section 816 does not appear to require that reserves be computed under a tradition formulaic approach, only that reserves are based on "assumed mortality and interest."

Under Section 807(d)(2), the amount of the reserve for any contract is determined using the tax reserve method applicable to the contract, the greater of the applicable federal or state assumed rate of interest, and the commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (*e.g.*, substandard risks) incurred under the contract which are not otherwise taken into account. Except for the designated tax reserve method, interest rate and mortality table, the federally prescribed reserve must be computed using the same actuarial basis as the statutory reserve. The term "prevailing state assumed rate" (PSAR) means the highest assumed interest rate permitted in computing life insurance reserves for insurance or annuity contracts (as the case may be) under the insurance laws of at least 26 states. In general, the term "prevailing commissioners" standard tables means the most recent commissioners' standard tables prescribed by the NAIC permitted to be used for reserve computations (for the type of contract at issue) under the insurance laws of at least 26 states upon contract issuance. If we work from the assumption that VM-20 will become CRVM once it is adopted, then how are the state assumed rate and commissioners' standard tables determined? Do the requirements of Section 807(d) limit deductible reserves to formulaic reserves having a fixed mortality and interest basis or have the definitions of commissioners' standard tables and prevailing state assumed rate been fundamentally changed by the implementation of PBR through revisions to the Standard Valuation Law? Are the appropriate mortality and interest assumptions those mandated for the net premium floor, or is a broader reading of the statute possible because of its deference to the NAIC? These are all questions that will need to be addressed in considering the extent to which stochastic reserves are incorporated into federally prescribed reserves.

If we work from the assumption that VM-20 will become CRVM once it is adopted, then how are the state assumed rate and commissioners' standard tables determined?

The last point that Peter mentioned when we began this discussion was the possible effect of outside influences. Peter, could one of those influences be a change in federal regulation of insurance which leads to the use of an accounting basis other than statutory, for example GAAP or IFRS?

Peter: I think the new reserve methods being developed by the IASB and FASB could have a profound effect on PBR generally, and tax reserves specifically, whether or not we ever get federal regulation of insurance. My belief (without much to back it up) is that there will be a lot of pressure on the NAIC (or future federal regulator) to abandon statutory accounting, at least for the statement of operations, if some version of the IFRS' proposed accounting for insurance contracts is adopted. Solvency concerns could be addressed by retaining some version of statutory accounting for the balance sheet or relying on risk-based capital (RBC) to ensure that insurance companies retain sufficient surplus. But, there is no compelling need as far as I am concerned to have different reserve methods for statutory, IFRS and GAAP to show the periodic emergence of profits. Furthermore, if book conformity occurs, there will be no compelling need to have one reserve method for statutory, GAAP and IFRS on the one hand and a different method for tax on the other. If I am right, then at some future date, we may

CONTINUED ON **PAGE 52**

find ourselves with a PBR-type statutory reserve that is the same as, or at least similar to, GAAP or IFRS, but without a net premium reserve floor, or even a deterministic reserve. The issues we have been focusing on this dialogue certainly would need to be addressed directly by the IRS or Congress to try to bring tax reserves more up to date.

Chris: As statutory reserve methods have evolved toward PBR, it is becoming more and more difficult for the IRS to audit tax reserves. The increasing development of actuarial guidelines by the NAIC as well as the increasing complexity of reserve methods has left both the industry and the IRS frustrated. Actuarial guidelines have emerged as a key tool for the NAIC and the industry by which emerging reserve methods are developed and communicated. In 1984, there were approximately a dozen guidelines; now there are more than 40. Moreover, guidelines are continually being updated, so the concept in Section 807(d)(3)(B) that the applicable method is that "in effect on the date of issuance of the contract" is becoming increasingly difficult to reconcile with the evolution of reserve standards, even without considering *American Financial*. Conceptually, PBR requirements are intended to be continually modified and adjusted as conditions warrant. Perhaps it is time to reconsider whether a separate tax reserve system is worth the cost compared to simply using statutory reserves, perhaps with controls on margins, similar to the "fair and reasonable" approach applied to loss reserves under Section 832. Placing the responsibility on taxpayers to demonstrate the methods and assumptions they relied upon to make their estimates are reasonable, perhaps in concert with the 10-year spread on a change in reserve basis under Section 807(f), may simplify the administration of the tax law without adversely affecting the resulting tax revenue from the life insurance industry. This may be particularly appealing if it is done as a part of a broad tax reform effort.

Mark: This has all been really interesting, Chris, but in some ways it leaves us with all the same questions we started with. I'd like to believe that in the broadest sense the lessons here are simple. First, we and the IRS are administering a system whose goal is clear reflection of income. Second, to achieve this goal the Internal Revenue Code instructs us to defer to reserve methodologies prescribed by the NAIC. I don't foresee broad tax reform changing either of these broad principles, nor do I see the actuarial profession declaring "mission accomplished" with the promulgation of VM-20. Peter may be right that IFRS could put tremendous pressure on the NAIC to abandon or at least change statutory accounting to achieve conformity with financial reporting. You may be right that the evolution of statutory reserve methods toward PBR has produced a complex and difficult-to-audit tax regime that serves neither companies nor the IRS well. It seems ironic, but at this point conformity with statutory accounting, however complex, is likely simpler than an approach that tries to fit new actuarial approaches into old tax rules. Simplification is truly in the eye of the beholder.

If I had a single word of advice for tax advisors and companies, and for my former colleagues in the government, it would be not to lose sight of the forest for the trees. Although many of the tax issues we wrestle with are binary, we are not working within a system of gotchas. We are working within a system that attempts to clearly reflect income, and that does so using reserve methodologies prescribed by nontax regulators.

Chris: I'd like to thank Peter and Mark for sharing their thoughts, and adding to the ongoing *Taxing Times* conversations on PBR. Whenever we have started a dialogue, it always seems any wisdom may be found along the way in the journey and not necessarily in the destination. That is certainly the case for me, as I never know where the conversation is going to turn until it actually heads there. In our discussion, we have tried to highlight issues that would be of interest to our readers and at the same time be somewhat provocative and thought provoking. In the spirit of open discussion and discourse, I'd like to invite any of our readers to join the conversation, either through a comment, article or a letter to the editor. I can be reached at *chris.desrochers@ey.com.*

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

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END NOTES

[1] Peter H. Winslow, *The Tax Reserve Method Should Be PBR Once It Is Adopted by the NAIC,* 24 Taxing Times, Vol. 4, Issue 3 (September 2008); Edward L. Robbins, *Calculation of Tax Expense in a Principles-Based Reserves Environment*, 24 Taxing Times, Vol. 4, Issue 1 (February 2008); Christian DesRochers, *Tax Uncertainty Swirls Around Principles-Based Reserves,* 15 Taxing Times, Vol. 3, Issue 3 (September 2007); Kory J. Olsen, *Tax Implications of Applying Principles-Based Reserves Retroactively,* 12 Taxing Times, Vol. 2, Issue 1 (May 2006); Joseph F. McKeever, III, John T. Adney & Lori A. Robbins, *The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System,* 1 Taxing Times, Vol. 2, Issue 1 (May 2006).

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[3] Peter H. Winslow, *Tidbit: Watch Out! The Three-Year Transition Period for Adopting Principles-Based Reserves May Not Apply to Tax Reserves,* 29 Taxing Times, Vol. 7, Issue 1 (February 2011); Emanuel Burstein, *Tidbit: The NAIC and Tax Concerns from the Implementation of the PBR Methodology,* 33 Taxing Times, Vol. 4, Issue 2 (May 2008).

[4] Thomas Gibbons, *Letter to the Editor,* 4 Taxing Times, Vol. 3, Issue 3 (September 2007).

[5] 2008-5 I.R.B. 363 (Jan. 14, 2008).

[6] 2010-15 I.R.B. 547 (March 25, 2010).

[7] *American Financial Group and Consol. Subs. v. U.S.*, 678 F.3d 422 (6th Cir., 2012), *affirming* 726 F.Supp.2d 802 (S.D. Ohio, 2010).

[8] *Cigna Corp. v. Commissioner,* T.C. Memo 2012-266 (Sept. 13, 2012).

[9] *State Farm Mutual Automobile Insurance Co. v. Commissioner,* ___ F.3d ___ (7th Cir., 2012), 2012-2 U.S.T.C. 50,542, *affirming* 130 T.C. 263 (2008), *affirming in part, reversing in part, remanding* 135 T.C. 543 (2010).

[10] Peter H. Winslow & Michael LeBoeuf, *How are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?* Taxing Times, Vol. 7, Issue 2 (May 2011).

HIGHLIGHTS FROM THE TAXATION SECTION'S 2012 PRODUCT TAX SEMINAR

By Brian King

This past September, the Taxation Section of the Society of Actuaries (SOA) sponsored a day-and-a-half-long seminar focused on taxation issues affecting products issued by life insurance companies. The Product Tax Seminar is held every two years in Washington, D.C. This year's seminar brought together industry experts, including representatives from the Internal Revenue Service (IRS), to discuss emerging product tax questions affecting life insurance, annuities and long-term care (LTC) insurance products.

Under the sponsorship of the SOA, the seminar brings together attendees from a variety of disciplines and backgrounds, including attorneys, compliance officers, policyholder administration system developers and other tax professionals. The diversity of backgrounds of those in attendance demonstrates the importance and reach of policyholder tax issues within insurance organizations.

Day 1 Agenda. The day 1 agenda focused on providing an update on current questions affecting the taxation of life insurance, annuities and long-term care products, with sessions addressing recent guidance and pronouncements issued by the IRS, including Notices, Revenue Procedures and private letter rulings (PLRs). Readers of *Taxing Times* will recognize the majority of these topics as most, if not all, have been addressed in recent issues of our publication. Items discussed on the first day of the seminar included the following.

Life Insurance:

- Definition of cash value under section 7702
- "Material changes" under the Internal Revenue Code (IRC) and the complexities of administering life-policy changes under the requirements of sections 7702 and 7702A
- Recent PLRs:
  - o PLR 201230009— the loss of 1980 CSO "grandfathering" resulting from a policyholder-elected decrease in death benefit
  - o PLR 201137008—the application of the section 7702A(c)(3)(B)(i) necessary premium test
  - o PLR 201046008—the section 7702 implications of a guaranteed distribution rider associated with a life insurance contract
- Revenue Procedure 2010-28 providing guidance on the application of sections 7702 and 7702A to life insurance contracts maturing beyond age 100
- Teaching session on the application of section 7702A(c)(3)(B)(i)'s necessary premium test

Annuities:

- Proposed regulations defining qualified longevity annuities contracts, or QLACs
- PLR 201235001 addressing investor-control questions
- Update on the tax and regulatory status of contingent deferred annuities
- Recent guidance on partial exchanges and partial annuitizations

LTC Insurance:

- Notice 2011-68 providing guidance on the taxation of LTC combination contracts
- Effect of the payment of LTC benefits on "investment in the contract"
- Exchange issues under section 1035
- Tax treatment of accelerated death benefits under sections 7702 and 7702A

Attendees at the seminar were fortunate to have Walter Welsh, executive vice president, Taxes & Retirement Security for the American Council of Life Insurers (ACLI), share his thoughts on the prospects for federal tax reform and ACLI's efforts to educate government officials on the important role played by life insurance and annuities in protecting the financial security of individuals and their families. Day 1 culminated with a networking reception hosted by Davis & Harman LLP, which allowed attendees to mingle with speakers and IRS representatives while enjoying the spectacular view overlooking the capital.

Day 2 Agenda. Day 2 of the seminar was focused on the broader concept of managing product tax risk. Maintaining qualification within the requirements of the IRC is essential

for the proper reporting of income to policyholders. Life insurers are keenly aware of the risks and challenges involved in administering insurance products within these requirements.

The morning session provided an overview of the IRC qualification rules for life insurance, annuities and LTC contracts; discussed sources of or instances in which noncompliance can arise; and highlighted the unfortunate implications for noncompliance. Further, panelists provided their insights on administrative practices that can mitigate the risk of qualification failures. The seminar concluded with an informative "Ask the Experts" session that provided an open forum for questions and answers that was led by Chris DesRochers and John Adney, along with IRS representatives Sheryl Flum and Don Drees.

Product Tax Seminar 2014. Several of the attendees have attended many of the past seminars, while some were attending their first. This provides an opportunity for those with product tax responsibilities to exchange views and learn the latest developments. We invite anyone who may be interested to mark their calendars for the next seminar, which will be held in Washington, D.C. in September 2014.

Sections 7702 and 7702A Boot Camp. Several attendees inquired about the status of the sections 7702 and 7702A "boot camp," which had been offered in conjunction with the Product Tax Seminar in prior years. In its continuing efforts to meet the demand for basic educational opportunities, the Taxation Section will be sponsoring a "Section 7702 & 7702A Boot Camp" at the SOA's Life and Annuity Symposium in May 2013 in Toronto, Canada. This day-long teaching session will focus on the basic qualification requirements of IRC sections 7702 and 7702A, and will provide an opportunity for attendees from a variety of backgrounds (legal, actuarial, compliance, IT, tax and so forth) to increase their knowledge in this area. For more information on the boot camp, please visit the SOA website at *www.SOA.org*. Hope to see you in Toronto.

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

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ACLI UPDATE

SENATE FINANCE COMMITTEE STAFF EDUCATION SESSIONS

By Walter Welsh, Mandana Parsazad and Pete Bautz

At the request of Senate Finance Committee staff, the American Council of Life Insurers (ACLI) and member companies collaborated in June, July and early August 2012, on a series of round table education sessions on life insurance products and companies.

The purpose of the sessions was to provide Congressional staff with a basic understanding of the types of products life insurance companies sell, how those companies conduct their business, and the tax rules that apply to companies. This education was intended to give some background for staff to consider legislative proposals impacting the life insurance industry and to provide appropriate information and support to senators and members of Congress.

Each session involved a specific topic, such as life insurance, annuities, regulation, etc. The tax rules for products were discussed in each of the sessions on products. The last session focused on company taxation. Representatives from ACLI member companies made the presentations in an informal setting designed to encourage questions and conversation.

Here is the list of sessions:

- June 1 – Life Insurance
- June 8 – Annuities
- June 22 – Disability Income Insurance
- June 29 – Long Term Care Insurance
- July 27 – Corporate Structure, Regulation, Accounting, Reserves, Capital and Risk Management
- August 3 – Company Taxation

If tax reform proceeds in 2013, these sessions will have provided valuable information to many Congressional staffers about the life insurance industry and the taxation of life insurance companies and products. ACLI continues to build on these sessions through follow-up meetings, as appropriate, with select members of Congress and their staffs.

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UPDATE ON MEETINGS WITH TREASURY AND INTERNAL REVENUE SERVICE ("IRS") ON PRINCIPLE-BASED RESERVES ("PBR") AND OTHER INDUSTRY PRIORITIES.

On July 10, representatives of ACLI met with Treasury/IRS Chief Counsel attorneys for a discussion primarily on company-related guidance plan items (PBR, AG 43, deficiency reserves, life-nonlife consolidated returns). The principal focus of the meeting was a summary of the current parameters of PBR (and particularly, the net premium reserve) and an update on the status of PBR at the National Association of Insurance Commissioners. We referenced the benefits of the open and ongoing dialogue between industry and government pursuant to Notice 2008-18 that led to the interim guidance on AG-43 tax considerations in Notice 2010-29. We emphasized the importance of a similar dialogue with respect to, and the need for timely government feedback on, PBR tax considerations. Following the meeting, we provided the government with details regarding the similarities between current CRVM and the net premium reserve.

ACLI also met on Aug. 7 with IRS Chief Counsel Bill Wilkins to emphasize the need for the IRS to dedicate resources to the provision of guidance on many evolving industry matters, including PBR, the section 807 statutory reserve cap under AG 43 and the inclusion of deficiency reserves in the statutory reserve cap. We also noted the continuing need for modernization of the life-nonlife consolidated return rules. We complimented Mr. Wilkins for the Service's cooperation and professionalism in handling the two industry issue resolution (IIR) projects impacting the insurance industry—the section 166 partial worthlessness IIR project and VA hedging IIR project.

Finally, on Sept. 18, ACLI met with Treasury Tax Legislative Counsel Lisa Zarlenga and Treasury Attorney-Advisors Lori Robbins and Krishna Vallabhaneni to provide an overview of industry priorities, including the need for tax guidance on

PBR, the statutory reserve cap under AG 43 and the inclusion of deficiency reserves in the statutory reserve cap. We also mentioned ACLI requests for revisions to the life-nonlife consolidated return regulations and guidance on combination annuity/qualified long-term care contracts. We thanked Treasury for its involvement in the VA hedging IIR project.

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

On Oct. 24, Treasury and IRS released Announcement 2012-42 which delayed the dates for compliance by withholding agents and foreign financial institutions (FFIs) generally from January 2013, or July 2013 to January 2014. These delays synchronize the dates for compliance for FFIs set in the proposed regulations with dates in the model Intergovernmental Agreements. It also provides additional time for:

- Completing Foreign Financial Institution (FFI) Agreements,
- Conducting due diligence with respect to pre-existing and new accounts, and
- Reporting with respect to recalcitrant accounts.

The ACLI welcomes the opportunity this delay provides for the industry to continue its constructive dialogue with the government particularly as it concerns the proposed rules' treatment of cash value life insurance and annuity contracts with values of $50,000 and less, and the treatment of beneficiaries of cash value life insurance and annuity contracts as owners of such contracts. Final regulations are expected by end of 2012 or beginning of 2013.

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

T[3]: *TAXING TIMES* TIDBITS

CIGNA UPDATE—MUCH ADO ABOUT NOTHING

By Peter H. Winslow

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

In the September 2011 edition of *Taxing Times,*[1] this author discussed the novel reinsurance argument presented in the *CIGNA*[2] case that relates to the persistent issue on the "retroactivity" of National Association of Insurance Commissioners (NAIC) actuarial guidelines (AGs) for purposes of computing tax reserves. The so-called "retroactivity issue" is really a misnomer. The question is: To what extent should a new AG apply for tax purposes for future years to contracts issued prior to the NAIC's adoption of the AG?

To review the bidding, under I.R.C. § 807(d), life insurance reserves generally are required to be computed in accordance with the tax reserve method prescribed by the NAIC (CRVM or CARVM) in effect on the date of issuance of the contract. The legislative history offers guidance as to how to interpret CRVM and CARVM for tax purposes. First, the company is required to use the method prescribed by the NAIC in effect on the date of issuance of a contract, and take into account any factors recommended by the NAIC for such contracts. The factors referred to in the legislative history are those recommended by the NAIC in model regulations and AGs recommended by the NAIC. Second, where no such factors are recommended, or for contracts issued prior to the NAIC's adoption of guidance, the company should look to the prevailing state interpretation of the Standard Valuation Law, *i.e.*, the interpretation that has been adopted by at least 26 states, if one exists. Finally, if there is no specific NAIC guidance or prevailing state interpretation, the company should use its statutory reserve approach as long as it was a permissible interpretation of CARVM or CRVM at the time the contract was issued.

The *CIGNA* case involved tax reserves computed under AG 34 for guaranteed minimum death benefits (GMDB) for tax years 2003 and 2004 attributable to variable annuity contracts issued prior to the NAIC's adoption of AG 34. CIGNA made a novel argument based on the fact that it had reinsured the risks from another insurer and CARVM technically may not apply to reserves held under reinsurance contracts. In such a case, CIGNA argued, the applicable Code provision is I.R.C. § 807(d)(3)(A)(iv) which provides that, for contracts not covered by CRVM or CARVM, the reserve method is the method prescribed by the NAIC "as of" the date of issuance of the contract. By its terms, AG 34 applied to reinsured risks under variable annuities with GMDB even though CARVM technically may not apply. Because the NAIC made AG 34 applicable to all contracts issued on or after Jan. 1, 1981, CIGNA contended that AG 34 is the NAIC-prescribed method "as of" that date.

The IRS disagreed and argued that reinsured annuity risks are still covered by CARVM, and that, because the contracts were issued prior to the NAIC's adoption of AG 34, CIGNA was required to use the method that was consistent with the prevailing state interpretation of CARVM for variable annuities with GMDB. Then, in a surprising development, the IRS conceded the case by asserting to the court that CIGNA's use of AG 34 reserves yielded a reasonable approximation of reserves computed using the prevailing state interpretation of CARVM as of the time the contracts were issued. This was a puzzling assertion because the Internal Revenue Service ("IRS") also acknowledged in its court filings that there was no uniform state interpretation of how CARVM applied to variable annuities with GMDB before AG 34 was adopted.

CIGNA refused to accept the IRS's concession. According to a pre-trial filing of the IRS, the IRS believed that CIGNA's refusal was motivated by its desire to apply AG 43 to its reinsured risks beginning in 2009 when that guidance was adopted by the NAIC.[3] If its "as of" argument under AG 34 prevailed, then presumably the same analysis would apply to permit AG 43 to have "retroactive" treatment as well. The Tax Court allowed the case to go to trial in September 2011, leaving open the possibility that the court either would enter a decision on the merits or would decide, in light of the IRS's concession of the tax in dispute, that the case was moot.

The Tax Court made its decision (or non-decision) in an opinion filed on Sept. 13, 2012. Not surprisingly, the court declined to decide the case on the merits, holding that it was

moot. A significant factor in the opinion is the court's reliance on the IRS's representation that it would not challenge CIGNA **or other taxpayers** that use AG 34 to compute tax reserves for GMDB for contracts issued prior to AG 34's adoption by the NAIC.

Other than the IRS's significant statement that AG 34 tax reserves will not be challenged, there is not much to be gleaned from the *CIGNA* case. But, two observations on the overall "retroactivity" issue can be made.

First, it may be fortuitous that the court did not decide the *CIGNA* case on the merits because, if the court had adopted either party's position, it may not have come to the best legal answer. Under the Sixth Circuit's well-reasoned opinion in *American Financial,*[4] CIGNA's AG 34 tax reserves should have been allowable because they were consistent with statutory reserves, were a permissible interpretation of CARVM at the time the contracts were issued and were not contrary to a majority-of-states uniform interpretation of the SVL.[5]

Second, the IRS may have learned an important lesson from its decision to challenge CIGNA's tax reserves. As was the case in the *American Financial* case, the IRS found itself having disallowed tax reserves computed in accordance with an NAIC guideline interpreting the same CARVM that existed when the contracts were issued. Yet, at the same time, in both *American Financial* and *CIGNA*, the IRS did not have a clear picture of what the "correct" tax reserve should have been under its 26-state position. The IRS's best option was to concede the *CIGNA* case and avoid another defeat. In light of the IRS's experience in *American Financial* and *CIGNA*, and with many tax reserve issues arising from the NAIC's adoption of AG 43 still unresolved, the IRS is likely to be wary of further litigation and we can expect guidance from the IRS that clarifies its position. ◂

END NOTES

1. Peter H. Winslow, *What Is the Tax Reserve Method "As Of" the Date of Issuance of the Contract?*, Society of Actuaries Taxing Times, Vol. 7, Iss. 3 (Sept. 2011).
2. *CIGNA Corp. v. Comm'r,* T.C. Memo. 2012-266 (Sept. 13, 2012).
3. Memo. Supporting Resp. Motion Entry of Decision at 6, July 14, 2011, Dkt No. 013645-09, ECF No. 0049.
4. *American Financial v. U.S.*, 678 F.3d 422 (6th Cir. 2012).

THE IRS EXCUSES AN UNINTENDED SEPP FAILURE

By Mark E. Griffin

The Internal Revenue Service ("IRS") in PLR 201235029[1] considered the exception to the 10 percent penalty tax under section 72(t)[2] for certain distributions that are part of a series of substantially equal periodic payments (the "SEPP Exception"). Consistent with the position it has taken in other private letter rulings, the IRS in PLR 201235029 concluded generally that an unintended failure to make payments as scheduled under the SEPP Exception would not result in a modification of the stream of payments that would trigger the application of the penalty tax. PLR 201235029 is of interest because it involves the distribution of an additional payment, unlike earlier rulings involving the failure to make a scheduled payment.

The Penalty Tax and the SEPP Exception

Section 72(t)(1) provides that if a taxpayer receives any amount from a "qualified retirement plan,"[3] including an IRA, the taxpayer's income tax for the year in which the amount is received is increased by an amount equal to 10 percent of the portion of the amount which is includible in gross income, subject to certain exceptions. The SEPP Exception provides an exception to this 10 percent penalty tax for distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his or her designated beneficiary.[4] Rev. Rul. 2002-62 sets forth three methods of making periodic payments that will be considered substantially equal periodic payments within the meaning of the SEPP Exception: the required minimum distribution method, the fixed amortization method, and the fixed annuitization method.[5]

However, if the series of payments is modified (other than by reason of death or disability) within five years, or before the employee attains age 59½, the previously avoided penalty tax is recaptured (with interest) in the year of the modification.[6] Under this recapture rule, the taxpayer's tax for the first year in which the modification occurs is increased by an amount equal to the tax that would have been imposed absent the SEPP Exception, plus interest for the deferral period.[7] Neither the

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Code nor the regulations under section 72 defines or describes what constitutes a modification to a stream of payments for this purpose.[8]

PLR 201235029

In PLR 201235029, Taxpayer A, age 50, was receiving monthly distributions from her IRA annuity in a manner that satisfied the SEPP Exception to the 10 percent penalty tax under section 72(t). Each distribution was made from Financial Institution A, the custodian of the IRA, to Financial Institution B, which then transmitted the distribution to Taxpayer A. On Date 1, Taxpayer A directed Financial Institution B to stop distributing funds at that time, and she began taking distributions directly from Financial Institution A. Nevertheless, she received a duplicate distribution from Financial Institution B on Date 2 and, despite requests by Taxpayer A, Financial Institution B failed to take the action requested to offset the duplicate distribution. Taxpayer A asserted that the additional distribution was due to a mistake made by Financial Institution B. She represented that she did not intend to modify the series of substantially equal periodic payments being made from her IRA annuity, had no reason to believe that Financial Institution B would distribute an additional amount on Date 2, and did not use the additional distribution for any other purpose.

Taxpayer A was concerned that the duplicate distribution could be viewed as resulting in a modification to the stream of substantially equal periodic payments being taken from her IRA. If so, and because she had not attained age 59½, her tax for the year in which the duplicate distribution was made would be increased under the recapture rule by an amount equal to the tax that she would have incurred previously absent the SEPP Exception, plus interest for the deferral period. For this reason, Taxpayer A requested a ruling from the IRS that the duplicate distribution did not result in a modification that would trigger the application of the recapture rule.

The IRS concluded that the additional distribution would not be considered a modification of the series of substantially equal periodic payments, and thus would not trigger the recapture rule or be subject to the 10 percent penalty tax under section 72(t)(1). In addition, Taxpayer A was granted a period of 60 days from the issuance of the private letter ruling to transfer the duplicate distribution back into her IRA annuity.

Observations and Conclusion

Neither the Code nor the regulations under section 72 provide that a taxpayer can self-correct, or that the IRS can waive, a modification to a stream of payments being made under the SEPP Exception. Absent some relief, even an inadvertent and unintentional failure to make payments in accordance with the SEPP Exception would constitute a modification to the series of periodic payments under the exception, trigger the application of the recapture rule, and result in increased tax to the taxpayer equal to the tax that would have been imposed absent the SEPP Exception (plus interest). The IRS in PLR 201235029 helped the taxpayer avoid these adverse tax consequences by taking the view that the failure—the duplicate distribution—did not constitute a modification in the first instance. This view is supported by the fact that (1) the failure was unintended, (2) the failure occurred as a result of an error on the part of a financial institution, (3) the duplicate distribution was not used by the taxpayer for any other purpose, and (4) the taxpayer would correct the failure by transferring the duplicate distribution back into her IRA annuity.

PLR 201235029 is noteworthy because it involves an additional distribution that caused distributions to fail to be made in accordance with the SEPP Exception. The IRS has taken a similar view in other private letter rulings to excuse certain unintended failures to make the necessary payments under the SEPP Exception where the taxpayer took an additional distribution to correct the failure.[9] Implicit in these rulings is that taxpayers who have failed to take the necessary distributions under the SEPP Exception might find it necessary to obtain a private letter ruling that the failure is excused by the IRS in order to avoid the application of the recapture rule.

END NOTES

1 Dated June 7, 2012, and released to the public on Aug. 30, 2012. A private letter ruling cannot cited as precedent, and only the taxpayer who received it can rely on it. *See* section 6110(k)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

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

3 A "qualified retirement plan" for this purpose includes (1) a qualified plan under section 401(a), (2) a qualified annuity under section 403(a), (3) a section 403(b) contract, and (4) an individual retirement account under section 408(a) and an individual retirement annuity under section 408(b) (collectively, "IRAs"). *See* section 72(t)(1); section 4974(c).

4 Section 72(t)(2)(A)(iv).

5 2002-2 C.B. 710, *modifying* Q&A-12 of Notice 89-25, 1989-1 C.B. 662.

6 Section 72(t)(4).

[7] *Id.*

[8] Section 72(q) includes a 10 percent penalty tax, SEPP Exception, and recapture rule for non-qualified annuity contracts that are virtually identical to those described above in section 72(t) for qualified retirement plans. See section 72(q)(1), (2)(D), and (3). The Treasury Department and the IRS have taken the position in Notice 2004-15, 2004-1 C.B. 526, that they will treat a distribution as satisfying the SEPP exception applicable to non-qualified annuity contracts in section 72(q) if the taxpayer uses one of the methods described in Notice 89-25, as modified by Rev. Rul. 2002-62, to determine whether the payment is part of a series of substantially equal periodic payments.

[9] *See* PLR 201051025 (Sept. 30, 2010); PLR 200930053 (Apr. 27, 2009); PLR 200835033 (June 3, 2008); PLR 200601044 (Oct. 12, 2005); PLR 200503036 (Oct. 25, 2004).

SOME RECENT LOOKS AT THE CONCEPT OF INVESTOR CONTROL

By Susan J. Hotine

The Internal Revenue Service (IRS) recently released two private letter rulings dealing with "investor control—PLR 201235001 (May 30, 2012) and PLR 201240018 (June 22, 2012). The issue of investor control generally has been associated with variable contracts and involves determining whether, based on general tax ownership principles, the holder of a contract with an insurance company possesses sufficient incidents of ownership over the investment assets being used to fund the company's contract liabilities that the holder should be treated as the owner of the assets for tax purposes. Whereas PLR 201235001 specifically involves variable annuity contracts, PLR 201240018 asks the question regarding indexed-linked investment options under a deferred annuity contract.

PLR 201235001

PLR 201235001 describes an insurance company's restructuring of a pooled, open-ended separate account of real estate investments (Separate Account) such that substantially all of the Separate Account assets will be transferred into a wholly owned subsidiary, which in turn will drop the real estate assets down into a second wholly owned subsidiary, both of which are described as disregarded entities for tax purposes (Disregard 1 and Disregard 2, respectively). Under this restructuring, the Separate Account will hold interests in Disregard 1, along with a few assets not transferred (that is, what remains after transferring "substantially all" of its assets). Funds from both pension and non-pension contracts are invested in the Separate Account. To the extent that any non-pension contracts continue in existence under the ultimate restructuring plan, the company will move interests in Disregard 1 equal in value to the cash value of the non-pension contracts from the Separate Account into a new Separate Account 2. As a result, pension contract funds will be invested through the Separate Account and non-pension contract funds will be invested through Separate Account 2. Following the establishment of Separate Account 2, the company will transfer the non-pension contract interests in Disregard 1 to NewCo, ownership interests of which will be publicly available.[1] Finally, although the company had and will continue to have complete discretion with respect to the investment of pension contract funds (within a broadly defined investment strategy for real estate), it will be limited in its investment of non-pension contract funds to only Disregard 1. A stated purpose of the restructuring of the company's pooled, open-ended real estate investment account into Disregard 1 and Disregard 2 is to allow interests in Disregard 1 to be owned, directly or indirectly, by non-insurance investors that are unrelated to the company. The IRS provides the requested rulings (1) that the company continues to be the owner of the assets underlying the pension contracts and (2) that the holders of the non-pension contracts will be treated as the owners of the assets underlying those contracts.

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After the restructuring, the pension contract deferred annuities and the non-pension contract deferred annuities will look very similar from an economic perspective because each will reflect investment (directly or indirectly) in the Disregard 1/Disregard 2 structure, which will be a publicly available investment structure that holds substantially all of the real estate investments originally held by the insurance company as the Separate Account. The pension contract holders will know that after the restructuring substantially all of their funds will be invested in the publicly available Disregard 1/Disregard 2 real estate investment structure. However, under the general real estate investment strategy provided for in the contracts, the insurance company is not required to put new funds in that structure or even to keep the current investments there, and the company made no promise to do so. In other words, the choice to invest in the publicly available Disregard 1/Disregard 2 structure is the company's and not that of the pension contract holders. By contrast, the company retained no such investment discretion with respect to the funds of non-pension contract holders. Going forward, the non-pension contract holders know that the company will invest non-pension con-

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tract funds only in the Disregard 1/Disregard 2 structure and that investment essentially will define the non-pension contracts. As a result of the company no longer having any choice regarding the underlying investments for the non-pension contracts, and because those underlying assets are comprised of a single, publicly available investment vehicle, the non-pension contract holders are treated as having made the choice to invest in a publicly available investment. The non-pension contract holders are treated as having investor control and so are treated as the owners of the underlying investment assets for tax purposes. Thus, the differing conclusions for the requested rulings seem to rest on the fact that the insurance company continues to retain complete discretion with respect to how pension contract funds will be invested in real estate investments, but does not have investment discretion with respect to non-pension contract funds.

The second ruling in PLR 201235001 is similar to that contained in PLR 200601007 (Jan. 06, 2006). As in PLR 200601007, the facts in PLR 201235001 clearly indicate that the non-pension contracts will not qualify as annuity contracts for tax purposes after the restructuring because they will not comply with section 817(h) diversification requirements. However, rather than the status of the contracts as annuities, the taxpayer's requested ruling is about ownership of the underlying assets—specifically that the contract holders, and not the taxpayer company, should be considered the tax owner of the underlying investment assets for the non-pension contracts.[2] It seems that the important consequence of the contract holders being treated as the owners of the underlying investment assets is that the contract holders are required to account for the investment income, gains or losses attributable to those assets for tax purposes and, thus, the company is not.

PLR 201240018

Although PLR 201240018 presents itself as an investor control ruling, it focuses on non-variable investment options of what otherwise is a variable deferred annuity contract. The variable investment options provide returns that reflect the investment return and market value of assets held by the company in sub-accounts of a separate account ("SA1") the assets of which are segregated from the general asset account and creditors. By contrast, the non-variable investment options provide formula-based returns that are indexed-linked to C1 and C2 (presumably indexes based on certain asset groups) so they reflect changes in the specified indexes over a stated duration. The facts state that the issuing company will hold the assets it purchases to support its indexed-linked liabilities in another account ("SA2") that is part of its general asset account, that the company will use its sole discretion in determining the nature and extent of any investments it makes to support these liabilities, and that the guaranteed indexed-linked return shields the contract holders from the investment risk associated with these assets. Although the indexed-linked investment options are characterized as allowing contract holders to diversify their deferred annuity contract portfolios by adding returns based on the indexes, the facts state that the holders' risk exposure is limited because losses on the company's actual investments will not affect the formula-based indexed-linked returns. Although the amount of cash in SA2 will equal the cash values of the indexed-linked investment amount attributable to the related contracts, the company has no legal obligation to invest in any specific assets and, if the contract holder makes a withdrawal from its indexed-linked investment option, the company can choose whatever general account assets it wants to use to pay the proceeds.

PLR 201240018 provides a detailed analysis of how the company has all the various ownership attributes associated with the assets supporting the indexed-linked investment options—a analysis that is like what might be said with respect to any general account assets underlying contracts that provide or assume a guaranteed return with respect to premiums paid into the contracts. And, as it might for any contract funded by general account assets, the PLR concludes that the issuing company enjoys the benefits and bears the burdens of owning the assets and should be treated as the owner for federal tax purposes. Conversely, the ruling notes that unlike in the investor control rulings the contract holders choosing indexed-linked investment options have no control over the purchase and disposition of the assets and receive a formula-based return that is completely independent of the investment return of the assets. It also notes that the contract holders are not investing directly in C1 and C2 (which is consistent with the fact that the indexed-linked investment return is based on a guaranteed formula and not the actual return on specific assets) and that the C1 and C2 indexed returns they receive are available only by purchasing the indexed-linked investment options of the contract (and not outside the contract). PLR 201240018 then concludes that the contract holders have no investment control over the investments supporting the indexed-linked investment options and therefore would not be treated as the owners of those assets for federal income tax purposes.

The issue of investor control arises under a variable contract because the contract reflects the investment return and market value of specific assets, which are segregated from a company's general asset account creditors and contract holders, and because the funds of the variable contract are in fact invested in those assets. Although these factors are not discussed explicitly in the investor control rulings, they are implicit in the definition of a variable contract. These factors generally are not present for contracts with guarantees that are supported by the company's general asset account, and these factors did not seem to be present for the indexed-linked investment options described in PLR 201240018. Even though certain assets within the general asset account had been identified by the company (SA2) as supporting the guarantee of the formula-based return for the indexed-link investment options, the facts seem to indicate that other creditors or contract holders of the general asset account would have a claim against those assets if needed (a fact that is generally true with respect to all contracts written on the company's general asset account). Although the facts set forth in PLR 201240018 appear to be very detailed in describing how the indexed-linked investment options work, numerous acronyms are used and are not well defined, making it difficult to say for certain to what extent the indexed-linked returns on the contract's cash value really are linked to specific assets owned by the company. Thus, it is not obvious on the face of the ruling's analysis why an investor control ruling was sought. However, there is a footnote that seems to indicate that the formula-based index-linked returns can be negative as well as positive, perhaps making the indexed-linked investment options a riskier investment than the usual guaranteed return options in other contracts based on the company's general account. The taxpayer may have sought the ruling because it thought that the existence of such an investment risk for the holder raised investor control issues. In any case, PLR 201240018 seems to confirm that, if the liabilities for contract guarantees are supported by assets in the insurance company's general asset account (and the company possesses all the asset ownership characteristics generally associated with the general asset account), the contract holder will not be treated as the tax owner of any assets held by the company to hedge or support those liabilities, even if the liabilities reflect guarantees that vary through use of a formula that can cause the guaranteed return to be both positive or negative. ◀

END NOTES

1. Although it is not stated in the ruling, presumably Disregard 1 will cease to be a disregarded entity for tax purposes when NewCo holds interests therein.
2. Note that the conclusion that a contract holder should be treated as the owner of the underlying assets does not necessarily mean that the remaining contract is not an annuity. *See* PLRs 200949007 (July 30, 2009) and 200949036 (July 30, 2009); PLR 201001016 (Sept. 14, 2009) (all holding that certificates providing customers of mutual funds with guaranteed minimum withdrawal or income benefits for the life of the customer will be treated as annuity contracts even though the certificates do not provide a cash value surrender benefit before the payments).

IRS ADOPTS BENEFICIAL APPROACH TO TACKING RULE

By Lori J. Jones

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For those who stay up at night worrying about whether a newly formed life insurance company can join an existing life/nonlife consolidated group, a new private letter ruling ("PLR") may be a reason for a good night's sleep. When a new life insurance company is excluded from the group, any ordinary and capital losses generated by the life company during a five-year waiting period cannot be used by the consolidated group during that period (or vice versa), and the tax effect of reinsurance or other intercompany transactions with the new company could differ. In PLR 201210015 (Mar. 9, 2012), the Internal Revenue Service (IRS) allowed a life insurance subsidiary to satisfy the "tacking rule" in Treas. Reg. section 1.1502-47(d)(12)(v) and join in the life/nonlife consolidated group as a result of a tax-free section 351 transaction that occurred several years after the subsidiary's formation and initial capitalization.[1] The key fact in the PLR was that the second section 351 transaction was of a sufficient size to constitute 80 percent of the assets acquired by the subsidiary outside the ordinary course of business at that time and, for the first time in that later year, the same tax character test was also met.

When a new life insurance or non-life insurance company is formed or acquired by a member of an existing life/nonlife consolidated group, the entity is treated as an ineligible corporation, unless the tacking rule applies. The basis for these rules

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is found in section 1504(c)(2) and section 1503(c)(2). Under section 1504(c)(2), no life insurance company can be included in a life/nonlife consolidated group until it has been a member of the affiliated group for the five taxable years immediately preceding a taxable year for which the consolidated return is filed. Under section 1503(c)(2), a nonlife company is includible in the group, but its net operating losses (NOLs) cannot be utilized against life insurance company income if such taxable year precedes the sixth taxable year such members have been members of the same affiliated group.[2]

The tacking rule in Treas. Reg. section 1.1502-47(d)(12)(v) is intended to apply when the new corporation is enough of a successor (using the term loosely and not as specifically defined in the consolidated return regulations) to the "old corporation" so that it can utilize (tack) the eligible status of the old corporation and join in the group as an eligible corporation. The rule contains four separate but interrelated requirements. The first requirement is that, at any time, 80 percent or more of the new corporation's assets it acquired (other than in the ordinary course of its trade or business) were acquired from the old corporation in one or more transactions described in section 351(a) or 381(a).[3] The asset test is applied by using the fair market value of assets on the date they were acquired and without regard to liabilities.[4] The second condition is that, at the end of the taxable year during which the first condition is first met, the old corporation and the new corporation must have the same tax character. The third condition is that, at the end of the taxable year during which the first condition is first met, the new corporation does not undergo a disproportionate asset acquisition as defined in Treas. Reg. section 1.1502-47(d)(12)(viii). The last condition is that, if there is more than one old corporation, the first two conditions apply to all of the corporations. Specifically, the last condition states that the tax character test must be met by all of the old corporations transferring assets taken into account in meeting the 80 percent test described above.

There have not been a significant number of private letter rulings or other IRS guidance addressing issues under the tacking rule. Rulings which have considered the tacking rule include: (i) TAM 9816001 (Nov. 20, 1997) (which concludes that the 80 percent test must take into account all transfers of assets that were made pursuant to an integrated plan so that satisfaction or failure to satisfy the tacking rule depended on whether employees transferred by a life insurance company member to a nonlife company member were an asset and, if so, whether the value of that asset comprised more than 20 percent of the total nonlife company's assets), (ii) FSA 862 (Oct. 8, 1992) (which concluded that the 80 percent test and the same tax character test had not been satisfied and the company was not eligible to make a life/nonlife election), and (iii) PLR 9211050 (Dec. 18, 1991) (where an eligible life insurance company purchased the stock of target for cash and then merged into target and the IRS held that the New Target (the merged entity) qualified as an eligible member of the life/nonlife group because 96 percent of New Target's assets were acquired from the eligible life insurance company in a section 381 transaction.)

PLR 201210015 focuses on the interplay between the first, second and fourth requirements of the tacking rule. Based on these requirements, one might conclude that if a corporation was formed and capitalized in one year and, in that same year, the new corporation and the old corporation in the section 351 or 381 transaction had different tax characters, e.g., one qualified as a nonlife insurance company and one qualified as a life insurance company, the tacking rule might never be satisfied. However, the PLR illustrates that such a failure can be cured in a later year if there is an additional asset transfer and, immediately after the additional transfer, 80 percent of the new corporation's assets have been received in a section 351 (or 381) transaction from the old transferor and both companies have the same tax character at the end of that later taxable year.

In the PLR, Parent was formed in Year 1 and Lifeco, a wholly owned subsidiary of Parent, was formed in Year 2. In Year 3, Lifeco formed a nonlife company (Sub). Prior to Year 5, Sub was licensed to issue life insurance products in certain jurisdictions, but had not conducted an insurance business. In Year 4, Parent elected to file a life/nonlife consolidated return, which included Lifeco and Sub.[5] In Year 5, Sub was expected to begin writing insurance business and qualify as a life insurance company under section 816. In Year 5, but prior to commencement of its insurance activities, Lifeco will contribute to Sub at least Amount 2 of additional capital (the "Capital Contribution"). (Prior to the Capital Contribution, Sub held investment assets which represented the capital contributed upon Sub's formation plus investment earnings (referred to as "Amount 1"). The PLR does not provide any additional information about the makeup of assets constituting Amounts 1 and 2.) It was represented that, immediately after the Capital Contribution, at least 80 percent of Sub's assets (based on the fair market values on the date of the Capital Contribution without liabilities) will have been acquired from Lifeco on account of the Capital Contribution. The Capital Contribution

also qualified as a section 351 transfer and it was represented that both Lifeco and Sub will qualify as life insurance companies at the end of Year 5.

In conclusion, the PLR is helpful because it allows the tacking rule to be satisfied even though Lifeco and Sub did not have the same tax character in the year in which the 80 percent is arguably "first" met, Year 3. Instead, the IRS concluded that the rule could be satisfied in a later year, Year 5, when both the 80 percent test and the same tax character test would be satisfied as a result of an additional capital contribution. This may be helpful in those instances when the new corporation is formed and capitalized by a life insurance company, but the reinsurance which will enable it to qualify as a life insurance company for federal tax purposes does not occur until a later year, if additional capital is also transferred to the new life company in the later year.[6] Such a result is likely the better answer from the consolidated group's point of view than if the tacking rule is not satisfied and the life insurance company has to file a separate federal income tax return during the five-year waiting period. ◀

END NOTES

1. Section 351 of the Internal Revenue Code of 1986, as amended, provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons in exchange for stock and immediately after the exchange such person(s) are in control of the corporation under section 368(c).
2. Under the regulations, in order to be an eligible corporation, a corporation must, for the five-year base period, (i) have been in existence and a member of the group, (ii) engaged in the active conduct of a trade or business, (iii) not experience a specifically defined change in tax character, and (iv) not undergo disproportionate asset acquisitions. Treas. Reg. section 1.1502-47(d)(12)(i). The reference to affiliated group in both section 1504(c)(2) and 1503(c)(2) is without regard to the exclusion for life insurance companies under section 1504(b)(2).
3. Section 381 applies to a section 332 liquidation or a reorganization described in section 368, other than a reorganization described in section 368(a)(1)(B) (voting stock for voting stock) or 368(a)(1)(E) (recapitalization).
4. There are some additional rules in the regulations regarding the 80 percent test. They include requirements that: (i) assets acquired in the ordinary course of business are excluded from total assets only if they were acquired after the new corporation became a member of the group (determined without section 1504(b)(2)), and (ii) assets that the old corporation acquired from outside the group in transactions not conducted in the ordinary course of its trade or business are not included in the 80 percent (but are included in total assets) if the old corporation acquired those assets within five calendar years before the date of their transfer to the new corporation.
5. According to a conversation with IRS Chief Counsel attorneys, there was sufficient time between Year 2 and Year 4 for Lifeco to satisfy the eligibility rules under Treas. Reg. section 1.1502-47(d)(12)(i). In other words, Year 4 was not two calendar years after Year 2, but was more than five taxable years after Year 2.
6. In the PLR, the IRS presumably concluded that change in Sub's tax character in Year 5 was not a prohibited change in tax character under Treas. Reg. section 1.1502-47(d)(12)(viii), *i.e.*, it was not a change attributable to an asset acquisition either within or outside the group in a transaction that is not conducted in the ordinary course of its trade or business. This rule similarly would have to be taken into account in the transaction proposed above in order for the new corporation to satisfy the tacking rule.

TAX COURT MEMO DECISION EXPLAINS THE TAXATION UPON THE TERMINATION OF A SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT

By Erinn Madden and Deborah Walker

The U.S. Tax Court addressed the tax consequences associated with the rollout of a split-dollar life insurance arrangement in *Neff v. Commissioner*, T.C. Memo 2012-244. Because this arrangement was entered into prior to finalization of the split-dollar regulations, the case analyzes the Internal Revenue Service (IRS) guidance for arrangements entered into on or before Sept. 17, 2003, including Revenue Rulings 64-328 and 66-110 and Notice 2002-8.

In March 2002, the taxpayers entered into split-dollar arrangements with their company under which the company paid premium payments on several life insurance policies owned by the taxpayers and family limited partnerships. Under this arrangement, the taxpayers agreed that on the termination of the policies or the split-dollar life insurance arrangement, the company was entitled to the lesser of the total premiums it paid or the cash surrender value of the policies. In December 2003, the company and taxpayers decided to terminate the arrangement. Prior to the termination, the company paid premiums of $842,345 and the cash surrender value was $877,432. No premium payments were made by the company after December 2003. An accounting firm calculated the present value of the reimbursement right of the company in the event of the taxpayers' death at age 85 using a 6 percent discount rate as

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$131,969. The taxpayers reimbursed the company $131,969, to release its interest in the policy and the taxpayers from any reimbursement obligation related to the additional $710,376 premiums paid. No amount was included on the taxpayers' return related to the termination of the arrangement. On audit, the IRS determined that the taxpayers realized taxable income of $710,376.

Under the rules in effect before the split-dollar regulations were finalized, the Tax Court indicated that the taxpayers were required to include the cost of the economic benefit in income each year less any amount contributed by the taxpayer. However, the taxpayers did not include any economic benefit in income. Although the taxpayers argued that the arrangements remained in effect, the Tax Court found that even though there was no written documentation of the termination, the arrangements were unwound and an effective rollout occurred because the company was released from its obligation to make premium payments and the company made no premium payments after December 2003. The taxpayers realized income under section 61, or alternatively the taxable transfer of property under section 83, of $710,376, which is the difference between the premiums paid on their behalf and the $131,969 amount reimbursed by the taxpayers. The Tax Court rejected the argument that there was a sale of mere contract rights at fair value. No penalties were assessed, the court acknowledging the complex nature of the transaction and the reliance by the taxpayers on professional advisers.

With the new regulations, fewer taxpayers have split dollar arrangements. Many arrangements entered into on or before Sept. 17, 2003 took advantage of generous transition rules provided in Notice 2002-8. Those that did not are now examining their arrangements and considering various alternatives. This case highlights the IRS position that termination of an arrangement can result in current income.

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