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# From the Chair Momentum for the Future!

By Housseine Essaheb

**A**s my tenure on the Taxation Section Council comes to an end, this is my final letter as chairperson. The past year has been productive on many fronts, and we should be proud of our achievements. I'd like to take a moment to reflect on the journey thus far and to offer a glance at what's on the horizon.

One of our missions is, and continues to be, to provide timely education on tax items impacting the insurance industry and the actuarial profession. With new tax legislation in the form of the Tax Cuts and Jobs Act of 2017, the tax section responded quickly and swiftly by offering education in several formats. We've helped produce webcasts and a special edition of *TAXING TIMES* and added to relevant sessions in Society of Actuary (SOA) meetings.

Following any significant change in tax law, it is common for U.S. Department of the Treasury or the IRS to provide guidance in areas where clarification is needed. In August, Treasury and the IRS released Proposed Regulations under Section 965, Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation. In addition, around the time of publication of this newsletter, we expect some form of guidance under new Section 59A, Base Erosion and Anti-Abuse Tax (BEAT). Proposed regulations for Section

951A, Global Intangible Low-Taxed Income (GILTI) have been released. You can expect us to provide information on this guidance in coming months.

From a section membership perspective, we noticed an increase in membership this year. More new section members have requested to be friends of the council, and all candidates running for section council this year are new members. These are signs of healthy engagement, and I hope that this trend continues.

My challenge to all section members is to please consider becoming a friend of the council. It's one of the easiest ways to get involved and to stay informed of what the section is planning. To get onboard, reach out to the section chair/co-chair and call into our monthly meeting.

We've had some outstanding moments in 2018, and I hope the momentum continues moving forward. There are many great challenges and opportunities ahead but with the help of the growing Taxation Section, we are perfectly positioned to take them on.

The success of the Taxation Section depends upon the contributions of our volunteers and the SOA staff. This is a group of incredibly talented individuals who have made my task of chairperson much easier.

Thank you all! ■

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# Accountant/Tax Attorney Dialogue on the History and Purpose of Internal Revenue Code Section 811(a)

By Richard Bush, Art Schneider, Mark Smith and Peter Winslow

## Note from the Editor:

Two years (and a major tax bill) have passed since *TAXING TIMES* completed a four-part series of dialogues on Internal Revenue Code deference to the National Association of Insurance Commissioners (NAIC). Part I of the dialogue discussed tax reserves;<sup>1</sup> Part II discussed policyholder tax issues;<sup>2</sup> Part III discussed insurance classification tax issues;<sup>3</sup> and Part IV discussed insurance tax accounting issues.<sup>4</sup> Together, the dialogue formed a basis for understanding the relationship between NAIC regulatory concepts on the one hand and Federal income taxation of insurers and policyholders on the other.

Recent developments—specifically, the enactment of the Tax Cuts and Jobs Act (“TCJA”)<sup>5</sup> and resulting efforts of life insurers and their advisors to implement that legislation—have drawn renewed attention specifically to Internal Revenue Code section 811(a), which provides rules for methods of accounting of a life insurance company. This dialogue discusses the history and purpose of section 811(a) and its historic role in the computation of life insurance company taxable income and, in particular, reserves.

We would like to thank our panel of highly experienced tax professionals. Peter Winslow of Scribner, Hall & Thompson LLP developed the concept for the original series and moderated all four parts; he graciously agreed to participate in this conversation as well. Mark Smith of PricewaterhouseCoopers LLP conceived of this dialogue and agreed to moderate it; Art Schneider, a consultant for both the American Council of Life Insurers and Transamerica, and Richard Bush of Ameriprise Financial, both have practiced in this area for decades. Combined, the participants in the dialogue have more than a century of experience in Subchapter L, dating back to years before the Deficit Reduction Act of 1984 (“the 1984 Act”).<sup>6</sup>

We hope you enjoy the conversation!

**Mark Smith:** Richard, Art, Peter, many thanks for joining.

We probably should start this conversation by pointing out the simplicity of section 811(a) itself. Labeled “Method of Accounting,” the section provides a general rule that all computations that are part of the tax calculation for a life insurance company are made under an accrual method of accounting, or a hybrid method to the extent permitted under regulations. It then goes on to provide something very important. Here, let me read it:

To the extent not inconsistent with the preceding sentence or any other provision of [the Subchapter L provisions that apply to life insurers] all . . . computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the [NAIC].

“Made in a manner consistent with the manner required for purposes of the annual statement.” That’s a mouthful, and maybe a little confusing. Nearly identical language has been in the Code since before some of our readers were born. Let’s talk about where it came from. Peter? Art? Who’d like to start?

**Art Schneider:** Before we jump into the legal analysis, I think it’s worthwhile to put section 811(a) in the context of tax accounting methods generally. The Internal Revenue Code, besides providing tax law, could also be viewed as providing financial accounting standards—in that sense operating similar to GAAP, statutory and IFRS financial accounting standards. That is, the determination of taxable income—and tax computations generally—could be viewed as just another set of financial records. These tax basis financial records are reconcilable to book-basis financial statements. For most corporate taxpayers, tax basis is reconcilable to GAAP financial statements. For life insurance companies, by virtue of section 811(a), tax basis financials are reconcilable to NAIC statutory basis financials. So, tax basis balance sheets can be reconciled to statutory basis balance sheets, the change in tax basis balance sheets can be reconciled to taxable income, and taxable income can be reconciled to statutory income. For life insurance companies, section 811(a) truly makes the NAIC annual statement basis of accounting the foundation of all tax basis computations, except to the extent provided elsewhere in Subchapter L or in other provisions of the income tax law. This includes tax reserves, as well as other liabilities and assets.

**Peter Winslow:** You are right, Art. I think the scope of section 811(a) is probably most important for tax reserves and a little history may be helpful. The predecessor of section 811(a) was former section 818(a) enacted in the Life Insurance Company Tax Act of 1959. Section 818(a), and now section 811(a), contained tax accounting provisions that were necessary for the first

So, in the 1984 Act, there was a change to reverse the ultimate holding of *Standard Life*, but not for its application of NAIC accounting to tax reserves. NAIC accounting for tax reserves was retained in section 811(a).

time because, immediately prior to the 1959 Act, life insurers were taxed only on their investment income. Expansion of the base to underwriting income required recognition that accounting methods for unique insurance items were needed because the usual accrual method of accounting based on the “all-events test” could not apply to every element of underwriting income, particularly reserves.

After the enactment of the 1959 Act, it was generally understood that section 818(a) meant that tax reserves were required to be determined on the basis of statutory reserves computed in accordance with NAIC statutory accounting. Statutory reserves had been the basis of the tax calculations of life insurance companies since 1913, even during the periods when life insurers were only taxed on investment income. In 1977, the Supreme Court in the *Standard Life* case<sup>7</sup> reconfirmed this principle pretty forcefully. At issue in *Standard Life* was the proper accounting treatment of deferred and uncollected premiums. The Court took as a given that state insurance law governed the computation of tax reserves and, therefore, tax reserves must take into account the assumption that deferred and uncollected premiums had been received. The issue, then, was whether the related unaccrued deferred and uncollected premiums should be included in income and assets, and, if so, whether on a gross or net basis. And, if gross, should they be offset by premium acquisition costs? The Supreme Court’s answer was that, because symmetry between premiums and reserves was required to clearly reflect income, accrual accounting concepts were not relevant. Reserves reflected unaccrued deferred and uncollected premiums and symmetry required at least some premium recognition on the income side whether or not the premiums had actually satisfied the all-events test. The Supreme Court held that section 818(a) required the use of the NAIC method “to fill the gap,” and required deferred and uncollected premiums to be included in income and assets, but only the net premiums reflected in reserves.

This was the state of play just before the 1984 Act. Section 818(a) required NAIC statutory accounting not only for tax reserves, but also for premiums and assets at least to the extent necessary to achieve accounting symmetry with the reserves.

**Mark:** But Congress reversed *Standard Life* in the 1984 Act, didn’t it?

**Peter:** Yes, but also in an important respect, no. The 1984 Act amended former section 818(a), which became what is now section 811(a). This amendment is interesting because, you are right, it legislatively reversed *Standard Life*. In *Standard Life*, as I said, the Supreme Court started with reserves and held that to achieve symmetry, NAIC accounting was necessary to override accrual accounting for premiums. But, in the 1984 Act, Congress basically said: We want accrual accounting to apply first to items that are susceptible to the all-events test—that is, to premiums and other similar items such as policyholder dividends; this is so even though NAIC accounting still applies for tax reserves—as it has since 1913. But, Congress went further and provided that we are now going to achieve symmetry between premiums and tax reserves by adding to section 811(a) special rules to make surgical adjustments to statutory reserves to the extent necessary to match premium income, which is now to be included in income on an accrual basis.

So, in the 1984 Act, there was a change to reverse the ultimate holding of *Standard Life*, but not for its application of NAIC accounting to tax reserves. NAIC accounting for tax reserves was retained in section 811(a).

**Mark:** What do you mean by surgical adjustments?

**Peter:** The treatment of deferred and uncollected premiums in the 1984 Act is the best example. Section 811(a) now says, in effect, that NAIC accounting applies only if it is not inconsistent with accrual accounting or another statutory provision governing taxation of life insurance companies. This means that accrual accounting now applies to premiums, but not to reserves, which are specifically allowed as deductions by the Code. To maintain symmetry with unaccrued deferred and uncollected premiums that are now excluded from income under the all-events test, section 811(c)(1) provides that a reserve cannot be established unless the related premium is included in income. Although this rule does not mention deferred and uncollected premiums, this is the provision that excludes net deferred and uncollected premiums from tax reserves.

**Mark:** That makes perfect sense. It’s interesting, at least to me, that under the 1984 Act, section 807(d)(6)—now, section 807(d)(4)—likewise made a “surgical” adjustment to the statutory reserves cap for deferred and uncollected premiums, unlike what it did for deficiency reserves, which are included in the cap but excluded from the Federally prescribed reserve. So, the broader point, I think, is Art’s point earlier, one would expect to look to the Code to find what reconciling differences there are between statutory accounting and tax accounting, generally.

Is there something to be learned here from tax-prescribed factors other than deferred and uncollected premiums? Richard, how would one historically have looked at the relationship between the composition of the Federally prescribed reserve on the one hand and the assumptions incorporated by section 811(a) on the other?

**Richard Bush:** The 1984 Act for the first time prescribed a tax method, interest rates and mortality tables, when applicable. But the committee reports and Blue Book make it clear that to determine tax reserves under the 1984 Act, except to the extent otherwise required, a company should begin with its statutory or annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well as the elimination of any net deferred and uncollected premiums and the elimination of any reserve in respect of excess interest. Thus, except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve (for example, whether to use a continuous or curtate function) should be consistent with those employed in computing a company’s statutory reserve.

That statutory reserves are the starting point for tax reserves is made clear by the case of *American Financial Group v. United States*.<sup>8</sup> The IRS appears to have argued that where tax reserves are based on statutory reserves, the company may not change its tax reserve method even if it changes its statutory reserve method. The Sixth Circuit correctly rejected the IRS position. The Court pointed to Rev. Rul. 94-74<sup>9</sup> as support, noting the ruling accepts that changes from one acceptable valuation method (for example, curtate to continuous) to another are permissible, even if it results in larger reserves. The case makes clear, for example, that if there is no prevailing State interpretation of CARVM or CRVM prior to the adoption of a new

guideline, and a company computes its statutory reserves using the new guideline, a company should compute tax reserves using the statutory reserve method (adjusted for tax interest rates and mortality). That is, a company that changes its statutory reserves to conform to the new guideline should likewise calculate its tax reserves using the guideline in the event there was no previous NAIC method or prevailing State method. The company is simply applying the rule that tax reserves must follow statutory reserves unless there is a prescribed method. A company may use the method prescribed by the guideline as the tax reserve method for contracts issued prior to its adoption where there is no prior guidance but would not be required to do so unless it changed its statutory reserve method to conform to the new guideline.

Consistently, in Rev. Rul. 89-43,<sup>10</sup> a life insurance company issued level premium, guaranteed renewable, group long-term care policies. The IRS held that the use of the company’s own experience met the requirement that life insurance reserves must be computed using a “recognized mortality or morbidity tables.” Thus, the company’s tax reserves were computed using the mortality table used for its statutory reserves.

**Art:** I like Richard’s point about how the legislative history of the 1984 Act continued to link the tax reserve computation to the statutory reserve computation, and it reinforces how section 811(a) underlies this result. The tax reserve computed under section 807(d) after the 1984 Act was often referred to as the “Federally prescribed reserve,” and I think people sometimes lose sight of how much of it was really NAIC-prescribed as opposed to Federally prescribed. As Richard notes, except for the five enumerated differences (four if you consider that the Federally prescribed method was generally the NAIC method), tax reserves under the 1984 Act followed statutory reserves. In this sense, the changes made by TCJA could be viewed as walking the tax reserve computation back even closer to statutory reserves by eliminating the requirements to use the prevailing interest rate and mortality or morbidity table in determining tax-basis life insurance reserves. In other words, while the 1984 Act was generally meant to allow companies the minimum reserve that most states would require to be set aside, TCJA has relaxed those minimum standard assumption requirements for reserves computed under section 807(d), so long as the assumptions are not inconsistent with the NAIC-prescribed method.

**Peter:** Before we get into how section 811(a) now applies to tax reserves under the new law, I think it’s important to point out a potential ambiguity in section 811(a). That section refers to the manner required for purposes of the annual statement approved by the NAIC. Does this mean the reporting required by a company’s domiciliary state regulator or does it mean the method required by applicable NAIC accounting guidance? In



my experience, prior to the 1984 Act, it was generally assumed that the reserves actually reported on the annual statement governed for tax reserves. Two events changed this result, however. For the Federally prescribed reserves (not the statutory reserves cap), the 1984 Act prescribed use of the NAIC method, which is not necessarily the method prescribed by a specific state regulator. More generally, the second event that occurred is the codification of the SSAPs in the early 2000s. Codification of NAIC statements of statutory accounting principles created uniformity in accounting and, as a consequence, at least in my view, when there is a conflict, the tie should be broken in favor of the guidance provided by the NAIC in implementing the accounting rules in section 811(a) over a single state regulator's views. By the way, there has been some litigation on this point under somewhat analogous provisions relating to taxation of property/casualty companies. An appeals court in a *State Farm*<sup>11</sup> case relied heavily on codification and NAIC guidance to hold that reserves for extra-contractual obligations are properly deductible as part of reserves for incurred losses.

**Mark:** We all agree that it is the NAIC method that governs for tax reserves under the new law. But, in the context of section 811(a), what does Art mean when he says that assumptions must be “not inconsistent” with the NAIC prescribed method? Is there a difference between assumptions that are inherently part of the method (and therefore prescribed as CARVM or CRVM regardless of what a company did) and assumptions that aren't part of the method but are used in applying the method? Also, does “not inconsistent with” mean that any assumptions are OK under section 811(a) so long as they produce a reserve that passes muster under the Standard Valuation Law?

**Richard:** There are assumptions that are not prescribed by CARVM or CRVM. For example, CRVM allows a company to use semi-continuous or continuous reserves but not curttate assumptions, *unless an immediate payment of claims (IPC) reserve is also held*. So, if a company computed its life insurance reserves using continuous functions on the annual statement, it would use those assumptions for tax purposes. However, if a company held curttate reserves without an IPC reserve, this is not allowed under CRVM, so tax reserves would have to be supplemented with an IPC reserve or be computed using either continuous or semi-continuous functions (subject to the statutory cap). Similarly, where a guideline may give a company a choice between methods, the use of any of the prescribed methods would apply for tax (consistent with the statutory reserve). Further, it seems to me that if a company failed (intentionally or not) to follow a prescribed method or part of a prescribed method, tax would not follow statutory and would need to be recomputed. Finally, I would just note that sometimes it is not entirely clear how CRVM or CARVM should be applied in a new or unusual fact pattern. I generally agree with Peter about

a single state's view of CRVM or CARVM, but I have a bit more nuanced view. Under the 1984 Act, the committee reports (and a couple of TAMs) say that the “prevailing” state interpretation of CARVM or CRVM applies in defining CARVM or CRVM for tax purposes, which I always took to mean 26 states (though this was never really defined anywhere). I think this notion probably carries over to the 2017 Act, since the reference to CARVM and CRVM carried over. So, if there was no prevailing view, a single state's interpretation of CARVM or CRVM should apply for tax purposes, so long as (in Art's words), the state's requirement was consistent with CARVM or CRVM. We are not talking about permitted practices, where a state is allowing a company to hold weaker reserves than the SVL might otherwise require.

**Art:** An interesting illustration of Richard's point about a guideline permitting a choice of prescribed methods could arise under the Practical Considerations section of Actuarial Guideline 33. That section notes that while the AG is intended to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams, other acceptable methods of applying CARVM that are substantially consistent with the methods described in AG 33 may be used, with prior regulatory approval. While allowed by the guideline (with prior regulatory approval), such other acceptable methods are not specifically prescribed in the guideline, and therefore might fall into the category of a permitted practice. If so, the reserves would have to be recomputed for tax purposes under the NAIC-prescribed method and then haircut by the 7.19 percent factor. Of course, if a permitted practice results in a lower statutory reserve, the statutory cap could apply.

**Peter:** I think I will call Richard's more nuanced view and raise him an even more nuanced view, which circles back to the meaning of section 811(a). It is true, as Richard says, that the 1984 legislative history refers to a prevailing state interpretation of the NAIC-prescribed method where no specific factors have been recommended by the NAIC. But I have always interpreted this legislative history as meaning that, in searching for the true NAIC-prescribed method, we should consider a clear prevailing interpretation of the states. After all, a majority of the state regulators effectively is the majority within the NAIC. But, if a company reports statutory reserves using a permissible interpretation of CRVM or CARVM that the NAIC would accept, I think there is a strong position that section 811(a) governs and the factor used for statutory reserves should be used whether or not a majority of other state regulators would impose or allow use of a different interpretation. The critical point is that statutory assumptions govern under section 811(a) unless they are inconsistent with the NAIC-prescribed method for the contract, or more generally, NAIC accounting principles reflected in model regulations or SSAPs.

**Mark:** Peter, I'm confused by the point you are making here. If the standard is whether the NAIC would accept a particular interpretation of CRVM or CARVM, wouldn't any interpretation of CRVM or CARVM always pass muster if it produces reserves that are greater than the reserves that would be produced by a prevailing interpretation?

**Peter:** What the NAIC would accept as allowable statutory reserves, and what the NAIC would permit as reserves computed according to CRVM or CARVM, may be two different things. What I am saying is that, if you can prove that statutory reserves are computed in a manner that the NAIC would agree is CRVM or CARVM, then there is no need to make an adjustment to the statutory reserve method. The problem is the proof. Where there is a single demonstrable prevailing state interpretation, it may be very difficult to show that statutory reserves computed in a different manner are also permissible under NAIC guidance. So, what I am saying is that, by reason of sections 807(d) and 811(a), it is the method used for statutory reserves that governs for tax as long as it is an interpretation of CRVM or CARVM that is permitted by the NAIC. It is not the prevailing state view as to what the NAIC-prescribed method should be. But, to repeat, if there is a prevailing state view, the legislative history points out that it should be considered in the absence of any other guidance from the NAIC.

**Mark:** Shortly before I left the insurance branch, a technical advice memorandum<sup>12</sup> rejected the "Connecticut Method" of reserving for variable annuities with guaranteed minimum benefits. According to the TAM, a prescribed assumption that the underlying assets experienced an immediate one-third drop in value was not part of CARVM because Connecticut was an outlier state in requiring it. The issue no longer exists because AG 43 now would apply, but is this the right way to approach a "method" question?

**Richard:** I think the TAM's approach was wrong, but it is not clearly so. First, it is not clear that the one-third drop method used actually met the definition of CARVM (the tax years at issue predated AG 34, so there was not a uniform interpretation of how to apply CARVM to these benefits). Connecticut did not think CARVM applied to variable annuities, so that could have been a way to get to the answer the IRS got to, though that is not what they relied on. My problem with the TAM is that the IRS seemed to define the "prevailing view" as the minimum reserve that would be required by 26 states, even if the states all had different views. I think the prevailing view means that 26 states must have a particular view of how to apply CARVM or CRVM before it becomes required for tax, not that the minimum reserve required by 26 states is the prevailing view, even if there is no standard interpretation.

**Peter:** But, we still are looking for an NAIC-prescribed method, not necessarily a prevailing state view. For tax reserves, we are going through a two-step process. First, under section 811(a), we are looking to see whether the statutory reserves reported in the annual statement are consistent with NAIC accounting generally. The second step is to see whether those statutory reserves are consistent with section 807(d), which requires use of the NAIC-prescribed method for the contract at the valuation date. In this second step, we have to see whether the reserves are part of the NAIC's definition of CRVM or CARVM. It is possible that a portion of statutory reserves may be reported in a manner that conforms with NAIC accounting, but is technically not part of CRVM or CARVM. A good example is the additional discretionary reserves required for the actuarial opinion by sections 3 and 6 of the Standard Valuation Law.

Think about Art's earlier example of AG 33. In AG 33, the NAIC specifically recognizes that the guideline is not the exclusive interpretation of the NAIC's own CARVM guidance. In effect, the NAIC is saying in AG 33 that there may be some contract benefits that AG 33 does not adequately address, and, if so, a state regulator is permitted to allow an adjustment to the specific rules in AG 33 as long as it is "substantially consistent" with AG 33 when considering that benefit; in such a case, we, the NAIC, will accept the regulator's method as compliant with the NAIC-prescribed method. It seems to me that in such a case the question that needs to be answered is whether the statutory reserve method permitted by the state regulator is substantially consistent with, or is a deviation from, AG 33 as contemplated by the NAIC.

A good illustration of the point I am making is AG 29 dealing with interpretations of CRVM and CARVM for restructured contracts issued by a company that is in court-supervised rehabilitation. AG 29 basically says that, because restructured contract provisions are fact-specific, a mechanical application of NAIC guidance may not be appropriate, and the proper interpretation of CRVM and CARVM should be left to state regulators. In other words, in these situations, the NAIC-prescribed method is whatever the state regulator decides, provided the state regulator is attempting to interpret CRVM or CARVM. Again, we get back to the basic question. Is the statutory reserve method prescribed by a single state regulator a permissible interpretation of the NAIC-prescribed method?

**Mark:** Can we get back to Richard's and Peter's "nuanced" and "more nuanced" views on the acceptability of a "method" under section 811(a)? It has been the case since 1984 that "method" is prescribed by section 807(d), and the manner of making "computations" follows the NAIC annual statement under section 811(a) as to items not otherwise prescribed by Subchapter L or regulations. How do we know whether an item is a "method"?



and therefore prescribed by section 807(d), or whether it is instead an item for which one follows what was done for the annual statement under section 811(a)? As to the former, there has been controversy over the years on what really constitutes CARVM or CRVM in the first place.

**Peter:** All reserves take into account contract-related future cash flows explicitly or implicitly. A reserve method simply sets forth how the assumptions as to those future cash flows are arranged together and whether the assumptions are explicit or implicit. An NAIC-prescribed method may specify prescribed assumptions or ranges of assumptions or leave the assumptions to actuarial discretion. So, the distinction between an NAIC-prescribed method that must be used and permissible assumptions that follow statutory reserve assumptions can be thought of as determining whether the statutory reserve assumptions for particular future contract-related cash flows are arranged in, and consistent with, the manner required and permitted in the NAIC-prescribed method. If so, those assumptions should be used for tax reserves even if other permissible assumptions would yield lower reserves.

**Mark:** What constraints might apply under section 811(a); that is, are there limits to simply following for tax purposes what assumptions are applied for stat?

**Art:** Richard can address the more technical aspects of your question, but I'd like to make a general observation. That is, contrary to what some people in the government seem to think, it is extremely rare that tax considerations are the primary, or even a leading, driver in determining statutory reserving assumptions in a company's NAIC annual statement. Instead, the level of statutory capital is nearly always the utmost concern. This is particularly true since the financial crisis. As our CFO used to say—his three principal concerns were “capital, capital and capital.” I think most any tax director at a domestic life insurance company would tell you that if they went into the CFO's office with an idea to increase statutory reserves (and reduce statutory capital) by \$1 with the idea of getting a tax deduction that, after TCJA, might get back 92.81 percent of 21 cents, they'd instantly get the boot. And, strange though it may seem, the initial effect of TCJA's corporate tax rate cut puts additional stress on capital levels. NAIC risk-based capital (RBC) ratios compare available capital to required capital, and a company's available capital consists primarily of its statutory capital. Statutory capital includes a limited amount of admitted deferred tax assets (DTAs) for future tax benefits, including reversal of statutory reserves in excess of tax reserves. The corporate tax rate reduction reduced the tax benefit of these future reversals, thereby decreasing the already limited amount of admitted DTAs and also decreasing available capital—the numerator of the RBC ratio. To add to the effect, required capital—the denominator of the RBC

ratio—has been increased. The reason is that required capital is based on extreme loss events and determined on an after-tax basis—like the Federal government is a partner (a limited partner because of potential tax law limitations on loss utilization) in the loss. The corporate tax rate cut reduces the government's loss-sharing percentage, thereby increasing required capital. Companies are finding that this double whammy has the effect of decreasing RBC ratios by 10 percent or more compared to pre-TCJA levels. Whether stakeholders—*i.e.*, shareholders, policyholders, regulators, rating agencies, investment analysts, etc.—will expect RBC ratios to be built back up remains to be seen. But the point is, there is a natural lid on annual statement reserving assumptions that almost inevitably outweighs tax considerations.

**Richard:** I do not think there is a “reasonableness” test for life insurance reserves, as there is for section 807(c)(2) reserves or for unpaid losses of property and casualty companies. The Code defines the method (and under the 1984 Act, mortality tables and interest rates) and there is no basis for the IRS to challenge a reserve computed using the prescribed assumptions because the reserve is “unreasonable” in relation to actual experience.

In *USAA Life Insurance Company v. Commissioner*,<sup>13</sup> the Fifth Circuit stated that a taxpayer does not need to show a tax-independent purpose in the calculation of reserves. In *UNUM Life Insurance Company v. United States*,<sup>14</sup> the First Circuit held that the way a taxpayer actually calculates reserves determines whether the reserves qualify as “life insurance reserves,” at least where the method is reasonable, accepted by the regulators and where the calculation was not made (to avoid life insurance reserve treatment) purely for tax reasons. In an old TAM,<sup>15</sup> the taxpayer had strengthened reserves from curtable functions to semi-continuous functions. This resulted in higher reserves. Actual mortality and interest experience of the taxpayer had been favorable. The IRS agent had maintained that in view of the underlying favorable experience, the taxpayer could not strengthen reserves. The National Office ruled that, “[t]he fact that the change in assumptions made in computing reserves . . . follows the practice of the taxpayer in paying death benefits but runs counter to favorable mortality and interest experience which the taxpayer has actually experienced is not relevant to a determination as to whether the taxpayer's reserves qualify as life insurance reserves. . . . Section 801(b) of the Code [now section 816(b)] does not prohibit reserve strengthening in the face of favorable experience on insurance risks.” In *Lincoln National Life Insurance Company v. United States*,<sup>16</sup> the Court stated that a company is entitled to strengthen reserves “where deemed necessary by the company in its business judgment.” In *United Fire Insurance Company v. Commissioner*,<sup>17</sup> the Seventh Circuit, in rejecting the Service argument that no additional reserve is required to be held during the two-year full preliminary term

reserve to qualify a contract as noncancelable during the first two years, stated: “We might find greater merit in the Commissioner’s position if it appeared that the preliminary term method of reserving were purely and simply a tax avoidance device. . . . But the preliminary term method has been widely adopted by insurance companies primarily for sound business reasons. It has been accepted and approved by the National Association of Insurance Commissioners and by all fifty states. The Commissioner does not suggest that the preliminary term method is merely a tax avoidance device, and we find nothing in the record to support such a conclusion.” In *Equitable Life Insurance Company of Iowa v. Commissioner*,<sup>18</sup> the Tax Court rejected the IRS’s argument that reserves for annuity guarantees for death benefits payable as a settlement option under its life insurance policies were overstated because the original reserve assumptions used to compute the additional reserve were not updated with available current information. The Tax Court noted that under Iowa law, an insurance company was allowed to adopt a standard for computing reserves that produced aggregate reserves greater than the minimum standard provided in the statute. The insurance company did not request or obtain the approval of the Insurance Commissioner of Iowa to adopt a standard for computing its additional reserves lower than the standard using the 1959 data. The Tax Court stated: “There is nothing in the Iowa law which requires a continual updating of the assumption on which reserves are based as long as the standard used by an insurance company results in reserves in excess of the reserves computed under the minimum standard. The reserves as computed by petitioner were included in its annual statement and were not questioned by the Iowa Insurance Commissioner even though there were three audits made of petitioner during these years.” And in *Lamana-Panno-Fallo Co. v. Commissioner*,<sup>19</sup> the Service had argued that reserves that were less than the amount required by state law did not qualify as life insurance reserves. Louisiana industrial insurers were not required to maintain reserves. The Louisiana Supreme Court later held that such companies were required to hold reserves, and the insurance companies were given several years within which to make up their reserve deficiencies, so for several years the reserves were deficient. The Fifth Circuit stated that it was not the function of the Service to question the sufficiency of the reserves but merely to ascertain whether reserves were required by law. Since the company was required to maintain the reserves, the reserves were required by law.

**Mark:** That’s a lot of case law authority, but does it mean that there is no reasonableness test for particular assumptions, either?

**Richard:** So, are there any limits? Could a company that held reserves using the 58 CSO Table or using a 1 percent interest rate get a deduction (subject to the haircut)? While Art points

out that most insurance companies would not use up their capital, this may not be as true for foreign captives or for hedge funds. And based on the discussion above, a court might find that an extra reserve held purely for tax reasons or which has no basis is not deductible, or perhaps is just a solvency reserve, though one would think the reserve would have to be extreme before a court would agree.

**Peter:** There is another aspect of section 811(a) that relates directly to the concept of reasonableness that we have been discussing. The accounting rules in the Code that govern for tax reserves are sections 811(a) and 807. In my opinion, this means that the general accounting provisions in section 446 that apply to other taxpayers, and even for most items of insurance companies, do not apply to tax reserves. Why is this important? It means that the IRS does not have the authority to impose an accounting method for tax reserves in an exercise of its discretion to require a clear reflection of income. There is no reasonableness test for tax reserves that can be imposed under the IRS’s authority in section 446; although, of course, there is an implicit reasonableness limitation to the extent statutory reserves are outside the scope of permissible assumptions that are compatible with the NAIC method.

**Mark:** Well, this is a lot of material to digest. Let me see if I can summarize what we’ve learned so far. First, section 811(a) is part of a comprehensive tax accounting regime that has started with the NAIC annual statement for many decades and made only limited, prescribed adjustments for tax. The 1984 Act legislative history reinforces this view. Second, if anything, one could view the TCJA as narrowing the differences between tax reserves and statutory reserves by reducing the number of tax-prescribed adjustments in section 807(d). In fact, if reserves are calculated in a manner consistent with CARVM or CRVM, the only adjustments one would expect to see are those that are prescribed in the Code, such as the 92.81 percent factor in section 807(d), or the rules for deferred and uncollected premiums or deficiency reserves. Third, not even the requirement that reserves be “reasonable” applies explicitly to life insurance reserves, though as Art points out, the likelihood a company would hold unreasonably high reserves is close to nil in most cases. There may be a situation where a company does so, but the standard for disallowing that for tax must be awfully high.

In short, the TCJA enhanced the role of section 811(a) in computing life insurance reserves such that one would expect fewer differences between statutory and tax reserves than under the 1984 Act regime. I know in prior *TAXING TIMES* Dialogues we have been cautious about using the term “deference,” but here the shoe does seem to fit.

**Art:** I think about it less as deference but more in terms of required consistency with the basis of tax accounting set forth by section 811(a)—that is, an accrual method of accounting which, to the extent not inconsistent with specific provisions of the Code, is to follow the NAIC annual statement method of accounting. And, as pointed out earlier in this discussion, the NAIC annual statement method of accounting is particularly important for reserves, which are not subject to normal accrual accounting principles.

**Richard:** My last comment just reflects on Art's capital is capital is capital comment. In a low interest rate and low tax rate environment, the benefit for increasing statutory reserves (just for tax reasons) in excess of required reserves is pretty small. One can establish mathematically that the tax benefit for holding an additional reserve (assuming it is 100 percent tax deductible) is effectively to convert taxable income to tax-exempt income. Ignoring the haircut, this means that the economics of a \$100 million tax reserve increase is to convert the income supporting the reserve into tax-exempt income. If a company earns \$5 million on that \$100 million (at 5 percent), the tax benefit is the tax savings on converting the \$5 million to tax-exempt income, or just \$1.05 million (21 percent of \$5 million). Further, only 92.81 percent of the reserve is deductible, meaning the tax benefit is just about \$975,000. A pretty expensive use of capital for a relatively small tax benefit. And, it should be remembered that the SVL generally requires a company to get permission from its domiciliary regulator to reduce reserves (other than additional reserves held under the Actuarial Opinion and Memorandum Regulation), and this may serve as another constraint.

**Mark:** Richard, Art, Peter, thank you so much for participating in this Dialogue. We probably need to wrap this up, but likely have not heard the last word on section 811(a). I hope this is as interesting to the readers of *TAXING TIMES* as it has been for the four of us.

**Disclaimer:** The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of their employers.

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## ENDNOTES

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- 17 *United Fire Insurance Co. v. Commissioner*, 768 F.2d 164, 171 (7th Cir. 1985).
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# In the Beginning . . . A Column Devoted to Tax Basics

## How are Qualified Annuities Taxed?

By Michael L. Hadley

Somewhere along the line, we all decided that when the universe was created, annuities were divided into two fundamental types—“qualified” annuities and “nonqualified” annuities. “Qualified” is the term used for annuities that are issued in connection with a qualified Code section 401(a) pension or profit-sharing plan, section 403(b) plan, section 457(b) plan, or individual retirement account or annuity (IRA), all of which receive special tax treatment under the Internal Revenue Code. These are sometimes collectively referred to as “qualified arrangements.” In the March 2016 issue of *TAXING TIMES*, my partner, John Adney, described the basic rules for nonqualified annuities but shrewdly left for another day the rules for qualified annuities.<sup>1</sup>

My task for readers is to open the door to the world of qualified annuities and the tax rules that apply to them, but the *most important* lesson you should take away from this article is that there are many kinds of plans and arrangements under which qualified annuities are issued, and the rules governing them differ considerably. An individual retirement annuity is not subject to the same rules as an annuity issued to a profit-sharing plan. A group annuity issued to terminate a pension plan is not subject to the same rules as a 403(b) individual annuity sold to teachers at educational institutions. In fact, the tax-preferred character of a qualified annuity, and the various rules it must satisfy, tends to flow not from the rules governing the annuity, but rather from the tax preference given to the particular plan or arrangement under the Code.

### THE TAX CODE'S MOST IMPORTANT EXCEPTION

I think of qualified arrangements as, essentially, the tax code's most important exception to the *constructive receipt* principle. A fundamental feature of our income tax code is that income from employment or investments is taxable in the year it is generated,

and this is true whether or not an individual wants to spend the income the same year—that is, income is “constructively” received even if the individual decides to save the income for the future.<sup>2</sup> A related rule—the *economic benefit* rule—provides that if an individual receives income in the form of an irrevocable contribution to a trust or annuity for the benefit of the individual, the individual is taxed immediately on that contribution, even if the individual cannot immediately access the trust, because the individual enjoys the “economic benefit” of knowing the amount is protected for the future.<sup>3</sup> The various rules for qualified arrangements are all built around avoiding immediate inclusion of income, either by deferring income tax on compensation paid for employment, or by deferring income on earnings paid on amounts held in these arrangements. All of these qualified arrangements eventually result in taxable income, however.

Congress created these very favorable income deferral arrangements to encourage individuals to save for retirement, and to encourage employers to offer retirement plans. Unlike some other employee benefits, the deferral is not a permanent exclusion. In contrast, for example, amounts an employer spends for a health care plan for its employees is completely excluded from the employees' income; not so for its 401(k) plan, which will eventually be taxed.

### EMPLOYER-BASED PLANS

Annuities are most commonly issued in connection with three kinds of plans maintained by employers for their employees:

- *Qualified 401(a) plans*, often just called qualified plans, including 401(k) defined contribution plans and defined benefit pension plans.<sup>4</sup>
- *Governmental 457(b) plans*, which are often offered to state and local government employees because, subject to a grandfather clause, most government employers cannot offer a 401(k) plan to employees.<sup>5</sup>
- *Section 403(b) plans*, which may only be maintained by employers exempt from income tax under Code section 501(c)(3) educational institutions, and certain religious organizations.

To regulate employer-based retirement plans, Congress has settled on a “carrot and stick” approach, and a well-administered annuity issued in connection with an employer-based plan should be cognizant of both. The “carrot” is very favorable tax deferral of contributions and earnings, but with a myriad of complex rules under the Code. The “stick” is the Employee Retirement Income Security Act of 1974, or ERISA, which imposes reporting, fiduciary and other requirements on most



plans,<sup>6</sup> and fairly significant penalties for noncompliance. Most of the obligations under ERISA fall on the employer or other fiduciary administering the plan, although some obligations are imposed on issuers of annuities sold to ERISA-governed plans, such as certain disclosure obligations. We will leave ERISA to the side for now and perhaps address it in a future “In the Beginning” article.

In general, annuities are used in the following three ways in connection with employer-based plans. First, annuities may be used to fund the plan. Second, annuities may be held as an investment asset in a trust that funds the retirement plan. For example, a plan might purchase and hold in trust a group annuity contract to provide a vehicle for offering and making life contingent annuity payments to participants. Finally, annuity contracts may be used to settle a plan’s benefit obligation. For example, an annuity contract may be distributed to a plan participant in a 401(k) plan, with the participant as the named owner. Similarly, when a defined benefit pension plan terminates, it generally must purchase an annuity contract to provide the plan’s promised benefits.

Section 403(b) plans, governmental 457(b) plans and qualified 401(a) plans receive very similar preferential tax treatment. In general, contributions to a qualified plan, section 403(b) plan or governmental 457(b) plan are excluded from an employee’s gross income under the Code and most state income tax laws, so long as the contributions satisfy certain conditions and limits. The earnings credited to the employee under the plan accumulate on a tax-deferred basis. Both contributions and earnings become taxable only when distributed to the individual. Once distributed, these amounts are taxable as ordinary income unless

rolled over to an IRA, a qualified plan, a section 403(b) plan or a governmental 457(b) plan. (More on rollovers below.) If the employer is a taxable entity, the employer may take an immediate deduction for contributions made to the plan, again subject to certain limits.

And this is the fundamental trade-off the Code makes between qualified and nonqualified arrangements. Unlike nonqualified annuities, the contributions made to annuities issued in connection with qualified arrangements may be made on a pre-tax basis (*i.e.*, the contributions are not included in the employee’s income even though they are essentially compensation for work done for the employer). But in exchange, the Code imposes a variety of contribution and benefit limits. For example, a qualified 401(a) defined contribution plan is subject to an annual limit on an employee’s elective salary deferral (\$18,500 in 2018) and on total contributions by both the employer and employee (\$55,000 in 2018). Plans are also subject to minimum coverage and nondiscrimination rules that are designed to ensure the plan covers an adequate cross-section of employees, not just the executives, and provides meaningful benefits to covered employees. Finally, the Code imposes restrictions on when a plan can distribute benefits to an employee—often restricting distributions while an employee is still working before attainment of age 59 ½.

*Roth contributions.* Qualified 401(a) plans, section 403(b) plans and governmental 457(b) plans may permit employees who make salary reduction contributions to designate some or all of those contributions as Roth contributions. Designated Roth contributions are currently included in an employee’s gross income under the Code. The earnings credited to the employee and attributable to the designated Roth contributions accumulate on a tax-free basis. In contrast to pre-tax salary reduction contributions, however, a distribution of an amount attributable to designated Roth contributions, including earnings, is entirely excluded from the employee’s gross income under the Code, although if a distribution is made before the individual reaches age 59 ½ and before the Roth account has been in existence for five years, the earnings on contributions will be taxable. Assuming an individual is in the same tax bracket at all times (and tax rates do not change), there is no effective difference between the tax treatment of a pre-tax contribution and a Roth contribution. However, the same Roth contribution produces a larger ultimate benefit in retirement than a pre-tax contribution of the same dollar amount because the employee effectively “pre-pays” the income tax.

*Loans.* Loans from an annuity contract issued in connection with a tax-favored retirement plan may be made on a nontaxable basis, provided that loans are permitted under the terms of the plan and the loans satisfy the requirements of Code section

72(p). Very generally, a loan is permissible if it does not exceed the lesser of (1) \$50,000, reduced by outstanding loans, or (2) the greater of one-half the present value of the participant's vested accrued benefit or \$10,000. In addition, to avoid treatment as a distribution, the loan must be repayable by its terms within five years,<sup>7</sup> and must be amortized in substantially level installments. If the loan fails to meet the foregoing requirements, for example because the employee fails to make required payments (violating the level amortization rule), the loan is "deemed" distributed, generating a taxable gross income for the employee of the amount of the outstanding loan.

*Penalty tax.* To encourage individuals to keep these savings preserved for retirement, an additional tax of 10 percent of the amount includible in gross income applies to early distributions from qualified 401(a) plans and section 403(b) plans.<sup>8</sup> There are numerous exceptions to the 10 percent penalty tax, including distributions made after the individual reaches age 59 ½ (55 if made after separation from service), death or disability.<sup>9</sup>

An exception to the 10 percent penalty that is commonly applied, and often misapplied, when annuities are involved is an exception for substantially equal periodic payments made after separation from service for the life or life expectancy of the individual, or the joint life or joint life expectancies of the individual and the designated beneficiary.<sup>10</sup> IRS guidance sets out three methods that can be used for calculating substantially equal periodic payments, including payments from deferred fixed and variable annuity contracts.<sup>11</sup>

*Rollover.* A rollover is a distribution that is paid into an IRA or another tax-favored plan to further delay income taxation. The terminology used for rollovers out of plans to IRAs (the most common rollover) is slightly different than when an individual moves from one IRA to another IRA. In the plan world, a "direct" rollover refers to a direct trustee-to-trustee transfer. An "indirect" rollover means a distribution paid to the individual that is then contributed to an IRA or other tax-favored plan. Such an indirect rollover generally must be made within 60 days of receipt of the distribution. By rolling over a distribution, an individual will avoid the 10 percent early distribution tax and defer income taxation until amounts are actually received in the future from the new plan or IRA.

*Distributed annuity.* Some of the most misunderstood sets of rules relate to an annuity distributed from a plan, particularly a qualified 401(a) plan; this is not the same as a rollover. If done correctly, an annuity can be distributed from a plan to the individual employee and the contract is tax-deferred (*i.e.*, tax is only assessed upon actual payments from the contract). This may be done as a distribution of an annuity contract (or certificate

under a group annuity contract) from a trustee plan issued in the name of the employee or as a transfer of title to an individual annuity contract. In order to preserve the tax-deferral, the distributed annuity must be nontransferable *after* ownership is transferred to the individual. If the contract is transferable after it has been distributed to the individual, the fair market value of the contract is taxable.<sup>12</sup>

Historically, annuity contracts have most often been distributed from qualified defined benefit plans in connection with the termination of the plan (what the industry calls "terminal funding" contracts). The distribution of the annuity contract effectively transfers the plan's liability to the insurer who is responsible for making payments. Annuity contracts are sometimes used in defined contribution retirement plans as an optional form of distribution. For example, a 401(k) plan might offer the individual the ability to receive his or her account balance in a single sum, in installment payments and in the form of a distributed annuity contract.

To regulate employer-based retirement plans, Congress has settled on a "carrot and stick" approach, and a well-administered annuity issued in connection with an employer-based plan should be cognizant of both.

There are a few additional rules that apply to distributed annuity contracts, so when a contract held under a plan is distributed to the individual, it is important that the proper endorsement is added. For example, the distributed annuity contract must reflect the spousal consent requirements of Code section 401(a)(11) and, as a result, the insurer is responsible for obtaining spousal consent to certain distributions and any lump-sum distributions must be calculated to satisfy the rules in Code section 417.<sup>13</sup>

*Taxation of after-tax contributions.* Most contributions to qualified 401(a) plans and section 403(b) plans nowadays are made on a pre-tax or Roth basis. But plans can also accept after-tax contributions, which are important to distinguish from Roth contributions, even though both are contributed on an after-tax basis. Roth contributions (and earnings if certain requirements are met) are distributed tax-free, whereas with after-tax contributions, the earnings will be taxed when distributed. To be more specific: Distributions from annuities held as part of a tax-favored retirement plan or from annuities that themselves have been distributed from a tax-favored plan are generally taxed under the rules in Code section 72. Under Code section 72, distributions are taxed as ordinary income, except to the

extent that the distributions represent what the Code calls the individual's "investment in the contract" but, in English, means amounts that have already been taxed. For qualified plans, that determination is generally made on a *pro rata* basis.

A simplified method for determining the nontaxable portion of amounts received as annuities from qualified 401(a) plans and section 403(b) annuities applies. Under this simplified method, the nontaxable portion of each annuity payment is calculated by dividing the investment in the contract by the number of monthly "anticipated payments." The number of anticipated payments is determined using Code-prescribed tables<sup>14</sup> based on the age of the primary annuitant (or combined ages for a joint and survivor annuity) on the annuity starting date. If annuity payments cease before the individual's entire nontaxable portion has been recovered because of the death of the individual, the amount of the unrecovered "investment in the contract" may be deducted by the individual in his or her last taxable year.

## INDIVIDUAL RETIREMENT ACCOUNTS AND ANNUITIES

There are two basic IRA forms—an *individual retirement account* under Code section 408(a) and an *individual retirement annuity* under Code section 408(b). An individual retirement account is a trust or custodial account that holds investments for the exclusive benefit of an individual or the individual's beneficiaries. An individual retirement annuity is an annuity contract that is issued by an insurance company which meets certain requirements, including that the annuity must be nontransferable, must be nonforfeitable and must allow for flexible premiums. Generally, an annuity issued as an individual retirement annuity includes an IRA endorsement to satisfy these and other key rules.

IRAs were created by Congress in 1974 to allow individuals who did not have a retirement plan at work to save for retirement. The annual contribution limits for IRAs are much lower than the employer-based plans described above (generally \$5,500 in 2018, with an additional amount for those 50 and older). Unlike plans, loans are not allowed from IRAs.

IRAs also come in two types based on their tax treatment—traditional IRAs and Roth IRAs. With a traditional IRA, contributions may be eligible for a deduction on an individual's return. Whether or not contributions to an IRA are partially or fully deductible depends on an individual's income, filing status, and whether the individual or his/her spouse participates in a retirement plan at work.<sup>15</sup> Whether contributions are deductible or not, earnings on contributions are not included in income until they are distributed from the IRA. Distributions generally are taxable except to the extent allocable to after-tax contributions (*i.e.*, contributions that the individual could not deduct) in

which case, like with employer-based plans, the amount that is not taxable is determined under the rules in Code section 72. A full description of exactly how to determine the ratio of pre- and after-tax amounts in each partial distribution or annuity payment is a bit complicated to go into here, but a couple overall points: First, the ratio is determined differently depending on whether the distribution is in the form of an amount received as an annuity or not; as you might guess, it is not always obvious whether the distribution is "in the form of an amount received as an annuity." Second, all traditional individual retirement accounts and annuities are treated as one contract and all distributions during a taxable year are aggregated. If no amount under an IRA represents an after-tax contribution, the entire amount of a distribution is includible in gross income.

Roth IRAs generally work in reverse. No deduction is allowed for contributions to a Roth IRA. When amounts are distributed from the Roth IRA, however, there is no inclusion in income (even on earnings), as long as the individual is at least age 59 ½ and the Roth IRA has been open for at least five years. Thus, Roth IRAs operate, from a tax standpoint, very similar to Roth amounts held in a 401(k) plan.

An individual generally can decide to withdraw or annuitize an IRA at any time, but to encourage IRAs to be preserved for retirement, the 10 percent penalty tax described above also applies to IRAs for distributions before age 59 ½. As with employer-based plans, there are numerous exceptions from the 10 percent penalty, and even a few that apply only to IRAs, such as for first-time homebuyers or higher education expenses.<sup>16</sup>

## REQUIRED MINIMUM DISTRIBUTION RULES

Both employer-based plans and IRAs are subject to what are known as required minimum distributions, or RMDs. The theory behind these rules is that since these tax-preferred arrangements are intended to fund retirement, they should not be allowed to accumulate tax-deferred income indefinitely and eventually must be distributed (and taxed). It is very important that any payments from a qualified annuity are made in compliance with the RMD rules.

The RMD rules require that distributions generally begin no later than April 1 following the calendar year in which the individual attains age 70 ½, or for employer-based plans, the year the individual retires if later. This date is known as the "required beginning date." Distributions then must be made over (1) the individual's life or the lives of the individual and his or her designated beneficiary; or (2) a period certain not extending beyond the individual's life expectancy or the joint life expectancies of the individual and his or her designated beneficiary. Distributions in the form of annuity payments must be made in periodic

payments at intervals of no longer than one year. The pre-death RMD rules do not apply to Roth IRAs.

At a high level, the amount that must be distributed each year under the RMD rules is based on whether or not payments are being made in the form of an annuity. Before the contract has been annuitized, each year's required payment is based on the account rules, essentially dividing the value of the annuity as of the end of the prior year by an IRS-prescribed factor based on remaining life expectancy.<sup>17</sup>

Once payments begin in the form of an annuity, the RMD rules in Treas. Reg. section 1.401(a)(9)-6 focus not so much on the amount distributed each year but in ensuring that the annuity payments are made in a form that prevents "backloading" of the annuity payments to improperly defer taxation.<sup>18</sup> And this is perhaps the most important regulation for actuaries working with qualified annuities to understand because it limits the options for annuity payout and is rife with traps for the unwary.

After the individual dies, additional rules apply.<sup>19</sup> If the individual dies *after* the required distribution of his or her interest has begun (*i.e.*, on or after the required beginning date), the remaining portion of the account or annuity must continue to be distributed at least as rapidly as under the method of distribution being used before the individual's death. If distributions have not begun in the form of an annuity prior to the individual's death but the death occurred after the required beginning date, this "at-least-as-rapidly" requirement is satisfied by distributing the remaining interest over the longer of (1) the remaining life expectancy of the deceased individual, and (2) the remaining life expectancy of the designated beneficiary.

If the individual dies *before* the required beginning date, distribution of the individual's entire interest must be distributed by Dec. 31 of the calendar year containing the fifth anniversary of the individual's death; or over the life, or over a period certain not greater than the life expectancy, of the designated beneficiary commencing on or before Dec. 31 of the calendar year immediately following the calendar year in which the individual died.<sup>20</sup> The after-death RMD rules are more generous, however, if the designated beneficiary is the individual's surviving spouse.

## CONCLUDING THOUGHTS

A "qualified" annuity is an annuity that has wrapped itself in the favorable treatment of a tax-preferred retirement arrangement. Understanding qualified annuities, and properly designing and administering them, really means understanding the complex rules that govern whatever arrangement under which the annuity is being held. Hopefully this high-level summary is a good start. ■

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## ENDNOTES

- 1 John T. Adney, "How are Nonqualified Annuities Taxed?" *TAXING TIMES*, Vol. 12, Issue 1, March 2016.
- 2 Treas. Reg. § 1.451-1(a).
- 3 *Spruill v. Commissioner*, 16 TC 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); I.R.C. § 403(a).
- 4 A defined benefit plan is a plan where the promised benefit is a defined amount, usually an annuity based on a formula taking into account the employee's compensation and years of employment. For example, the plan might define the benefit as a single life annuity (with other optional forms available) starting at age 65 equal to 1 percent of the employee's average annual compensation times the employee's years of service for the employer. The plan must pay that benefit, regardless of the assets held in the plan or the investment results of the plan's trust, and the law requires the employer to set aside sufficient assets to fund the benefit. A defined contribution plan—and a 401(k) plan is the most common modern example—defines the benefit as simply the amount contributed by the employer and the employee, plus or minus earnings.
- 5 Governmental 457(b) plans differ from tax-exempt 457(b) plans. Tax-exempt 457(b) plans are a form of deferred compensation plan that may be maintained by nongovernmental tax-exempt entities (*e.g.*, charities and private universities). Tax-exempt 457(b) plans are generally not funded [although the employer may hold annuities as an informal funding method for a tax-exempt 457(b) plan]. Governmental 457(b) plans, in contrast, must be funded by a trust or by annuities, and thus operate very similarly to other types of tax-favored retirement plans.
- 6 There are certain plans that are exempt from ERISA, including plans of state and local governments and plans of churches.
- 7 There is an exception to the five-year payment rule for loans used to acquire a principal residence.
- 8 Distributions from a governmental 457(b) plan are not subject to the 10 percent additional tax, unless the distribution is attributable to an amount that was rolled over to the governmental 457(b) plan from a qualified 401(a) plan or section 403(b) plan.
- 9 A similar 10 percent penalty tax applies to distributions from nonqualified annuities before age 59 ½. See I.R.C. § 72(q).
- 10 One common trap for the unwary is a change in the method of determining the substantially equal payments, which can result in recapture of the penalty tax.
- 11 See Q&A-12 of Notice 89-25, as modified by Revenue Ruling 2002-62, which describes the required minimum distribution method, the fixed amortization method and the fixed annuity method.
- 12 Treas. Reg. §1.402(a)-1(a)(2).
- 13 Treas. Reg. §1.401(a)-20, Q&A-2.
- 14 I.R.C. § 72(d)(1)(B)(iii).
- 15 I.R.C. § 219. The rules for determining whether or not a contribution is deductible are summarized in IRS Publication 590-A, which is a good resource for learning the basics of IRA contributions.
- 16 I.R.C. § 72(t)(2)(E), (F).
- 17 Treas. Reg. § 1.401(a)(9)-5.
- 18 Treas. Reg. § 1.401(a)(9)-6.
- 19 Treas. Reg. § 1.401(a)(9)-2, Q&A-5; 1.401(a)(9)-5, Q&A-5.
- 20 Treas. Reg. § 1.401(a)(9)-3.



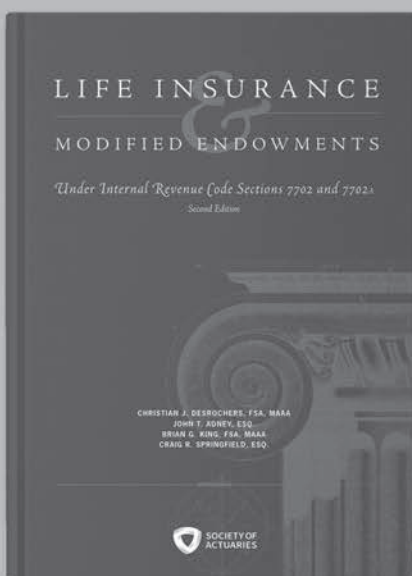


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# John Adney, Editor Emeritus

From the Editorial Board of *TAXING TIMES*



As noted on the cover, this is the 14th volume and third issue of *TAXING TIMES*. Our first issue was published in May 2005. John Adney's efforts and contributions have been one of the cornerstones of this publication and its success during this time, a remarkable record of service to our profession as actuaries and to his own profession of law. Beginning with this October 2018 issue of *TAXING TIMES*, John has retired from our editorial board and has been named an Editor Emeritus to this publication.

John has contributed countless articles, sage advice and sound professionalism to the editorial board, authors and editors of

*TAXING TIMES*. Looking back at our prior issues, John's influence as a writer has been significant. In the very first volume in May 2005, John penned an article with Joseph McKeever and Craig Springfield concerning the effects of qualified additional benefits (QABs) under Revenue Ruling 2005-6. John's 2012 article (with Chris DesRochers, Brian King and Craig Springfield) on Material Changes is often cited in industry forums, providing valuable insight into a difficult and complex topic.

John's work with *TAXING TIMES* also can be viewed in the broader context of his contributions to our profession. Consider the following:

- John penned articles in the 1980s that helped define how the Deficit Reduction Act of 1984 (DEFRA) and Technical and Miscellaneous Revenue Act of 1988 (TAMRA) affected the tax treatment of insurance companies and their products. His insight into the governing statutes and tax law changes, as well as into the process and history of our profession, has always been apparent, including in his recent contributions to the "In the Beginning . . ." series of *TAXING TIMES*.
- The textbook *Life Insurance and Modified Endowments* (both first and second edition) with Chris DesRochers, Brian King, Craig Springfield and Doug Hertz is the principal resource used by actuaries to explain the difficult life insurance compliance rules.<sup>1</sup>
- John has been a prolific speaker at Society of Actuary meetings on a variety of tax topics and how they affect our industry.

John, the editorial board of *TAXING TIMES* thanks you for all of your service to the Taxation Section and to the SOA. ■

## ENDNOTES

- 1 And include helpful footnotes such as "See, for example, 'Creature from the Black Lagoon' (1954)." John, this one's for you.



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# ACLI Update

## Tax Reform 2.0

By Mandana Parsazad and Regina Rose

In late July, U.S. House Committee on Ways and Means Republican leadership released a Framework on Tax Reform 2.0 (Framework) to extend permanently the tax cuts for middle-class families and small businesses. The two-page document sets forth three areas that the next iteration of tax reform will cover. In addition to extending individual and small business provisions of the Tax Cuts and Jobs Act of 2017, Tax Reform 2.0 will focus on individual savings initiatives and business innovation.

According to the document, Ways & Means leaders will encourage individual retirement savings by introducing proposals that will help local businesses provide retirement plans for their workers and help workers participate in those plans. Proposals will also encourage family savings by creation of Universal Savings Accounts, expand Internal Revenue Code Section 529 education savings accounts, and allow families to access retirement accounts penalty-free for expenses associated with the birth or adoption of new children. Proposals will also encourage innovation by helping new businesses write off more of their start-up costs.

Although the description of new incentives to promote retirement savings in the Framework is vague, it may include provisions from the Retirement Enhancement and Savings Act (RESA), a bipartisan Senate bill. RESA includes several provisions to improve and enhance the current employer-provided retirement system. These include:

1. a provision to help workers understand the value of their retirement benefits by providing an illustration of how their account balance translates into monthly lifetime income in retirement;
2. a provision clarifying the current Employee Retirement Income Security Act of 1974 (ERISA) safe harbor to assist employers adding an annuity option to their retirement plan offerings; and
3. a provision to expand retirement plan access through multiple-employer plans (“Open MEPs”) by permitting employers without retirement plans the ability to join together to achieve economies of scale in plan administration.

The ACLI (American Council of Life Insurers)/life insurance industry has expressed support for RESA. House Ways & Means Chairman Kevin Brady has expressed his support for including some of the provisions in RESA in Tax Reform 2.0. One such provision may be introduction of the “Open MEP” described above. At the time of this article, it is unclear the extent to which other provisions from RESA may be included in the next iteration of tax reform proposals introduced by Ways & Means Republicans.

As described, the proposals in Tax Reform 2.0 to encourage family savings appear to be focused on short-term savings, with the proposal to expand current education savings accounts having perhaps the longest term. Universal Savings Accounts are described as “fully flexible,” which may not bode well for long-term financial security planning. Moreover, the proposal to allow families to access retirement accounts penalty-free for expenses associated with the birth or adoption of new children could significantly erode existing retirement savings. Detailed legislation is expected to be introduced in late summer or early fall, so by this article’s publication date, more details may be known about the types of retirement incentives being proposed as well as how those may be impacted by shorter-term savings incentives, which could allow for early withdrawals from retirement accounts.

### INDEXING CAPITAL GAINS TO INFLATION

In Washington the adage “everything old is new again” is a fact of life, and it holds true for one of the Trump Administration’s tax policy ideas: to allow individual taxpayers to account for inflation in computing the amount of their capital gains tax liability. For over a year, senior Administration officials have advocated for indexing capital gains to inflation, with some proponents of the idea arguing that the U.S. Department of the Treasury has authority to effect such a change in computation of capital gains taxes without legislation. This idea was considered by the George H. W. Bush Administration in 1992. At that time, Treasury concluded it did not have the authority to issue guidance that would allow taxpayers to index their capital gains taxes to inflation in the absence of legislation. The legal basis for such a move could be stronger now, with several intervening court cases that could buttress the argument for the Administration to take action.

However, it remains unclear at the present time whether the current Administration will conclude that legislation is required for such a change in the computation of capital gains taxes. Treasury Secretary Steven Mnuchin indicated this summer that Treasury is studying the issue and will consider what the department can do unilaterally if legislative efforts are unsuccessful. In late July, Rep. Devin Nunes (R-Calif.), a senior House Ways & Means member, introduced a bill that would adjust the basis of certain

capital assets to account for inflation for non-corporate taxpayers. The bill defines assets that may be indexed as indexed assets (generally, stocks traded on exchanges), and tangible property that is a capital asset or property which is used in a trade or business [IRC section 1231(b) property]. If the taxpayer holds an asset for more than three years, then the basis in such asset is increased by reference to an inflationary index based on the gross domestic product. Assets held in Real Estate Investment Trusts and Registered Investment Companies may be indexed to the extent shareholders are non-C corporations.

Chairman Brady has not indicated that this issue is a priority for the Committee, or whether he will include such a proposal in Tax Reform 2.0. The likelihood of a legislative pathway for the idea depends on Senate support and whether Republicans maintain control of both chambers after the 2018 mid-term elections.

ACLI and its member companies are assessing the implications of Mr. Nunes' bill to life insurance industry companies and products. Modifications may be warranted to include inflation indexation for assets held by corporate taxpayers. Moreover,

the bill could put long-term financial security and guaranteed lifetime income at a significant competitive disadvantage as compared to products offered by other industries if it is not modified to address inflationary impacts on annuity contracts and other retirement savings products life insurers offer. ACLI plans to work with Mr. Nunes, and other legislators, as well as Treasury to maintain parity of treatment for products across industry lines as these proposals are being considered so that life insurers and their policyholders are not inadvertently penalized. ■

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# T<sup>3</sup>: TAXING TIMES Tidbits

## Proposed Regulations on “Toll Tax” Under Amended Section 965<sup>1</sup>

By Surjya Mitra

One of the hallmarks of the Tax Cuts and Jobs Act of 2017<sup>2</sup> (“TCJA,” or “Act”) is the imposition of a one-time “toll tax” on the undistributed, non-previously taxed post-1986 foreign earnings and profits (E&P) of certain U.S.-owned foreign corporations as part of the transition to a new territorial tax regime. The Act amended Section 965, which uses the mechanics of the subpart F regime to impose this tax.

On Aug. 1, U.S. Department of the Treasury and the IRS released lengthy proposed regulations under Section 965 (the Proposed 965 Regulations). The Proposed 965 Regulations, divided into nine sections, incorporate the rules described in prior guidance and introduce additional guidance on a range of issues relating to the implementation of Section 965.

The following provides a few highlights of the rules set forth in the Proposed 965 Regulations and the impact such rules have on the determination of various aspects of the toll tax calculation.

### GENERAL: E&P

Section 965(a) increases the subpart F income of a “deferred foreign income corporation” (DFIC) for the last taxable year of such DFIC that begins before 2018 by the greater of tested E&P (*i.e.*, accumulated post-1986 deferred foreign income) measured on Nov. 2, 2017, or Dec. 31, 2017 [the Section 965(a) earnings amount]. For these purposes, a DFIC generally is any “specified foreign corporation” (SFC) that has positive earnings as of either measurement date. If Section 965 applies, a U.S. shareholder’s toll tax liability is determined by undertaking the following step-by-step approach: (1) measure post-1986 E&P of SFCs, (2) allocate E&P deficits, (3) calculate aggregate foreign cash position (AFCP), (4) compute allowed deductions under Section 965(c), and (5) determine foreign tax credits allowed.

A U.S. shareholder of a DFIC is required to include in income under Section 951(a)(1) its *pro rata* share of the Section 965(a) earnings amount of each DFIC. If, however, the taxpayer is a U.S. shareholder with respect to at least one DFIC and at least one “E&P deficit foreign corporation” (*i.e.*, an SFC with an accumulated E&P deficit as of the applicable measurement date), then Section 965(b) provides that the portion of the Section 965(a) earnings amount which otherwise would be taken into account under Section 951(a)(1) by the U.S. shareholder with respect to each DFIC is reduced by the amount of such U.S. shareholder’s “aggregate foreign E&P deficit” that is allocated to such DFIC. Therefore, in accordance with Sections 965(a) and (b), a U.S. shareholder of a DFIC must include in income under Section 951(a)(1) (as an increase to each DFIC’s subpart F income) its *pro rata* share of the Section 965(a) earnings amount of each DFIC, adjusted for the reduction provided by Section 965(b) [the Section 965(a) inclusion amount].

The Proposed 965 Regulations provide rules relating to E&P adjustments to account for the application of Sections 965(a) and (b). The Proposed Regulations also provide that Section 961(b)(2) gain which otherwise would be recognized as a result of a distribution from a DFIC in the toll tax year generally is



reduced (but not below zero) by the amount of Section 965(a) previously taxed income [Section 965(a) PTI]. This gain relief provision is also available with respect to Section 965(b) PTI for U.S. shareholders who make the election under Prop. Reg. sec. 1.965-2(f).

Prop. Reg. sec. 1.965-2(c) provides that a DFIC will have previously taxed E&P with respect to Section 965(a) inclusion amounts [referred to as the “Section 965(a) previously taxed E&P”]. For these purposes, any Section 965(a) inclusion amount is required to be translated (if applicable) into the functional currency of the DFIC using the spot rate on Dec. 31, 2017. Such Section 965(a) previously taxed E&P also reduces Section 959(c)(3) E&P of the DFIC. A deficit in E&P described in Section 959(c)(3) will be created or increased when the Section 965(a) inclusion amount with respect to the DFIC exceeds the E&P described in Section 959(c)(3) of the DFIC (e.g., when a DFIC sustains a loss after the measurement date).

#### E&P DEFICITS

Prop. Reg. sec. 1.965-2(d)(1) provides that any reduction to a DFIC’s Section 965(a) earnings amount will be considered previously taxed income under Section 965(b) [Section 965(b) PTI]. A parallel rule is provided for E&P deficit foreign corporations in Prop. Reg. sec. 1.965-2(d)(2), whereby such entities’ E&P is increased by the *pro rata* share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under the reduction rules. For purposes of determining the Section 902 or Section 960 deemed paid credit associated with such deficit foreign corporation, such increase is deemed to occur on the first day of the first taxable year following the toll charge year.

Prop. Reg. sec. 1.965-2(e) provides rules for basis adjustments by reason of Section 965(a). Under Section 961(a), a Section 958(a) U.S. shareholder’s basis in Section 958(a) stock of a DFIC, or property by reason of which the Section 958(a) U.S. shareholder is considered as owning the Section 958(a) stock of a DFIC (applicable property), is increased by the Section 958(a) U.S. shareholder’s Section 965(a) inclusion amount with respect to the DFIC.

Prop. Reg. sec. 1.965-2(f) permits taxpayers to elect to make the following basis adjustments: (1) an increase in the Section 958(a) U.S. shareholder’s basis in the Section 958(a) stock of a DFIC or applicable property with respect to a DFIC by an amount equal to the Section 965(b) PTI of the DFIC with respect to the Section 958(a) U.S. shareholder, and (2) a corollary reduction in the Section 958(a) U.S. shareholder’s basis in the Section 958(a) stock of an E&P deficit foreign corporation or applicable property with respect to an E&P deficit foreign corporation by an

equal amount. This election must be made consistently for all foreign deficit corporations of the U.S. shareholder (and related persons), and in certain circumstances can give rise to gain.

#### PARTICIPATION EXEMPTION AND AFCP

Section 965(c) allows a U.S. shareholder of a DFIC to deduct, in each taxable year for which it has a Section 965(a) inclusion amount, a portion of the increased Section 951(a)(1) inclusion. The deductible amount is computed in a manner whereby, with respect to a domestic corporation U.S. shareholder, the Section 965(a) inclusion amount is taxed at a 15.5 percent effective rate to the extent of the U.S. shareholder’s aggregate foreign cash position and an 8 percent effective rate to the extent the inclusion exceeds the U.S. shareholder’s AFCP.

The Proposed 965 Regulations provide important rules for the determination of the “toll tax.”

The definition of AFCP under the Proposed 965 Regulations is consistent with prior administrative guidance. The preamble discusses several exceptions to the definition of AFCP requested in comments due to their insufficient “liquidity,” including cash held or attributable to an entity that is engaged in a regulated industry, such as life insurance. However, the Treasury and IRS provided no specific exceptions, pointing to legislative history and the statute itself, and difficulty of administering a rule that would provide exceptions. Comments are invited with respect to this issue.

#### FOREIGN TAX CREDITS

The Section 965 inclusion amount is treated as a dividend carrying deemed paid foreign taxes, but Section 965(g) provides that no credit will be allowed for 55.7 percent of the foreign taxes deemed paid with respect to the portion attributable to the AFCP, plus 77.1 percent of the foreign taxes paid with respect to the remainder of the mandatory toll tax inclusion. In other words, the foreign income taxes treated as deemed paid or accrued by a domestic corporation as a result of Section 965 are limited to those taxes in proportion to the taxable portion of the Section 965 inclusion amount.

The foreign tax credit provisions set forth in the Proposed 965 Regulations restrict the foreign tax credits allowed in connection with the toll tax in three distinct ways: (1) Prop. Reg. secs. 1.965-5(b) and (c)(1)(i) clarify that the section 965(g) disallowance applies to foreign taxes deemed paid under Section 960 as well

as any taxes imposed on the distribution of Sections 965(a) and (b) PTI; (2) Prop. Reg. sec. 1.965-5(c)(1)(ii) prevents taxpayers from claiming a credit for the portion of a foreign corporation's foreign taxes not deemed paid under Section 960(a)(1) because of the allocation of E&P deficits; and (3) Prop. Reg. sec. 1.965-6(c)(3) defers the Section 965(b)(4)(B) increase to the E&P of E&P deficit foreign corporations for purposes of Section 902.

In addition to the foreign tax credit disallowance provisions discussed above, Prop. Reg. sec. 1.965-6(d) prohibits taxpayers from treating as tax-exempt assets attributes created under the Section 965(a) inclusion [e.g., the Section 965(c) deduction, Sections 965(a) and (b) PTI, and the assets that give rise to them] for purposes of apportioning interest and other expenses. This includes the treatment of some or all stock as a tax-exempt asset under Section 864(e)(3).

### ANTI-AVOIDANCE

Prop. Reg. sec. 1.965-4, consistent with Notice 2018-26, provides an anti-avoidance rule whereby the following transactions are disregarded for purposes of Section 965: (1) transactions undertaken with a principal purpose of changing the amount of a "Section 965 element" of a U.S. shareholder (as described below), (2) certain changes in method of accounting and entity classification elections, and (3) certain transactions occurring between measurement dates.

### SECTION 965 ELECTIONS

Prop. Reg. sec. 1.965-7 provides guidance regarding eligibility, procedural mechanics, and timing for the following elections and payments: (1) Section 965(h) (elections to pay in installments) elections; (2) Section 965(i) elections (regarding S corporations and partnerships); (3) Section 965(m) elections [deferred inclusion for real estate investments trusts (REITs)]; (4) Section 965(n) elections [elections not to apply net operating loss (NOL) deductions]; and (5) the election to use the alternative method for calculating post-1986 E&P (the alternative method election).

Generally, the Proposed 965 Regulations require taxpayers to make the elections described above no later than the due date (with extensions) for the return for the related taxable year. The related taxable year for each election is determined by reference to the individual proposed regulation section. In order to make

the elections, taxpayers generally must attach a statement, signed under penalties of perjury, to their return that includes, but is not limited to, the taxpayer's name and taxpayer identification number. Relief under Treas. Reg. secs. 301.9100-2 or -3 is not available to make late elections.

### AFFILIATED GROUPS

Prop. Reg. sec. 1.965-8 provides rules clarifying the application of Section 965 and the proposed regulations to members of an affiliated group [as defined in Section 1504(a)], and members of a consolidated group [as defined in Treas. Reg. sec. 1.1502-1(h)]. For purposes of Prop. Reg. sec. 1.965-8 only, all members of a consolidated group that are Section 958(a) U.S. shareholders of an SFC are treated as a single Section 958(a) U.S. shareholder for purposes of allocating aggregate foreign E&P deficits. However, each member of the consolidated group must separately compute foreign income taxes deemed paid with respect to a Section 965(a) inclusion.

### CONCLUSION

The Proposed 965 Regulations provide important rules for the determination of the "toll tax." The Proposed 965 Regulations are generally proposed to apply beginning in the last tax year of a foreign corporation that begins before Jan. 1, 2018, and to U.S. persons beginning in the last tax year in which or with which the tax year of such a foreign corporation ends. Corporate taxpayers that are U.S. shareholders in foreign corporations which are on a calendar year basis would have to generally report the impact of section 965 in their 2017 U.S. tax return, whose extended due date is Oct. 15, 2018. ■

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### ENDNOTES

- 1 This article is based on an alert issued by PwC's Washington National Tax Office: "IRS Issues Lengthy Proposed Rules on 'Toll Tax' Under Amended Section 965," August 2018.
- 2 P.L. 155-97.



# Captive Evaluation in Reserve Mechanical

By Jean Baxley and Catherine Moore

Many public and non-public entities use closely held insurance companies, often referred to as captive insurance companies, to ensure the risks of their affiliates. These captives may or may not qualify as insurance companies for U.S. federal income tax purposes. Section 816(a), which is specifically cross-referenced in section 831(c), defines an “insurance company” as “any company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies.”<sup>1</sup> Moreover, to qualify as insurance for U.S. federal tax purposes, an arrangement must satisfy a number of judicially created tests. Among the nonexhaustive list of requirements are: (1) presence of insurance risk; (2) the shifting of risk from the insured to the insurer; (3) the distribution of risk by the insurer; and (4) other considerations that are grouped together as “commonly accepted notions of insurance.” Corporations that satisfy these requirements are entitled to the special benefits afforded to a captive arrangement (*e.g.*, deductibility of premiums and “insurance company” treatment). Each arrangement’s specific facts and circumstances should be considered when evaluating qualification as an insurance company for tax purposes. Recently, in *Reserve Mechanical Corp. v. Commissioner*,<sup>2</sup> the U.S. Tax Court addressed insurance company qualification for a captive entity and concluded that the taxpayer’s arrangement did not constitute insurance for the reasons discussed below.<sup>3</sup>

## FACTUAL OVERVIEW

### Reserve, the Captive

The qualification of captives as insurance companies has been litigated for many years, most recently in *Reserve Mechanical*. Reserve Mechanical Corp. (f.k.a. Reserve Casualty Corp.) (“Reserve”) was organized in 2008 in Anguilla and had a section 953(d) election in place for 2008–10, the tax years at issue. Reserve was wholly owned by Peak Casualty Holdings LLC (“Peak”), an Idaho S corporation. Peak was owned by two U.S. persons who each had a 50 percent interest in the stock of Peak and each of whom acted as a director for Reserve.

Peak was engaged in the business of distributing, servicing, repairing and manufacturing equipment used for underground



mining and construction. During the relevant years, Peak had between 13 and 17 employees. At all times during the relevant years, Peak maintained third-party insurance coverage for general liability, workers’ compensation, commercial property, inland marine, automobile and international risk.

Peak’s owners also equally co-owned 100 percent of the membership interests in two partnerships: RocQuest LLC (“RocQuest”) and ZW Enterprises LLC (“ZW”). RocQuest held various real estate interests including the property it leased to Peak. ZW was organized to help finance a loan to a former employee. In exchange for the assistance, ZW owned 10 percent of the former employee’s business.

### Capstone

The owners of Peak were introduced to Capstone, a “turnkey” services provider for captive administration and management. Capstone was formed by the managing partner of a law firm that provided legal services to Capstone clients.

Capstone provided a captive feasibility study to Peak that concluded “the viability of a small captive insurer . . . to address the insurance and risk management issues discussed herein is feasible, reasonable, and practical, and is the best alternative risk mechanism option for the proposed insured.” The feasibility study was issued jointly with Willis HRH of Houston, an insurance broker and risk management consulting firm. Following the feasibility study, Reserve was incorporated on Dec. 3, 2008. On Dec. 10, 2008, Reserve received an initial capitalization of \$100,000.

From 2008–10, Reserve issued direct written insurance policies including coverage for 11 to 13 different lines such as excess directors and officers liability, excess pollution, loss of major customer, excess cyber risk and product recall. Peak, RocQuest and ZW were the named insureds on each policy. All of the

policies issued showed one premium price but did not allocate the amounts to be paid by each insured. The policies listed PoolRe Insurance Corp. (“PoolRe”) as the stop-loss insurer for the coverage. Additionally, each policy stated that it applied only after other (presumably commercial) coverages were exhausted.

Only one claim, for loss of a major customer, was made from 2008–10. The initial claim was for \$164,820 and Reserve paid the total amount of the claim once the insured had signed a release. Subsequently, an extended claim was made and Reserve issued another claims payment on the same loss event in the amount of \$175,000.

### PoolRe

PoolRe is an insurance company domiciled in the British Virgin Islands. PoolRe’s operations were administered by Capstone. For each of the tax years in issue, Reserve and PoolRe executed a joint underwriting stop-loss endorsement that applied to all direct written policies that Reserve issued. Pursuant to these agreements, PoolRe agreed to serve as a joint underwriter and stop-loss insurer for the direct written policies that Reserve issued. According to the stop-loss agreement, Reserve was the lead insurer with respect to the policies and PoolRe assumed an amount of excess risk in exchange for 18.5–19.9 percent of the total combined premiums due from the insureds. During the years at issue, PoolRe also entered into similar endorsements for approximately 400 policies that between 51 and 56 Capstone clients issued; that covered in the aggregate around 150 insureds.

From these various endorsements, PoolRe pooled the premiums that it was entitled to receive and executed reinsurance agreements designed to redistribute them to Capstone entities. Reserve and the other Capstone entities each executed with PoolRe a quota-share reinsurance policy pursuant to which each entity agreed to assume coverage for a specified portion of the risks that PoolRe had assumed according to the stop-loss endorsements. The quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop-loss endorsement.

### CreditRe

For the relevant tax years, Reserve executed with PoolRe a credit insurance coinsurance contract, under which Reserve agreed to assume a small portion of risk that PoolRe had assumed from an unrelated company, Credit Reassurance Corp. Ltd. (“CreditRe”). The coinsurance contracts stated that CreditRe ceded to PoolRe a *pro rata* share of the liability and premiums associated with its large pool of vehicle service contracts (these contracts originated with a large U.S. direct insurer). Under the

coinsurance contract, Reserve reinsured from 0.9100 to 1.1576 percent of PoolRe’s annual liability. PoolRe executed similar coinsurance contracts with other Capstone clients.

## TAX COURT ANALYSIS AND TAKEAWAYS

### Risk Distribution

The first issue addressed by the Tax Court was risk distribution. Based on the number of insureds and the total number of independent risk exposures, the Court concluded that the policies Reserve issued directly were insufficient to distribute risk. In reaching this conclusion, the Court referenced *Rent-A-Center*,<sup>4</sup> *Avrabami*<sup>5</sup> and *Securitas*<sup>6</sup> but did not provide a bright line test for how many entities (*i.e.*, legal entities) and/or how many independent risk exposure units (*i.e.*, number of employees, vehicles, locations) would be sufficient to achieve risk distribution.

It is likely that the IRS will continue to challenge the validity of captive arrangements.

The Court then turned to the stop-loss endorsements, quota-share reinsurance arrangement and credit coinsurance contracts as they relate to risk distribution. Reserve stated that through these arrangements, 30 percent of its gross premiums for each tax year was from insuring unrelated parties.<sup>7</sup> Citing *The Harper Group*, Reserve claimed that this percentage of third-party premium income was sufficient to achieve risk distribution.<sup>8</sup> To determine if risk distribution was achieved, the Court first looked at whether PoolRe was a legitimate insurance company. As stated above, the quota share Reserve assumed was calculated so that Reserve was entitled to receive payments from PoolRe equal to the premiums that PoolRe was entitled to receive from Peak and the other insureds pursuant to the stop-loss endorsement. The Court also noted: (1) Reserve did not have any losses related to the quota-share arrangement; (2) there was no evidence that these arrangements were priced on an arm’s length standard; and (3) there was no evidence that PoolRe was likely to ever suffer any economic loss pursuant to the stop-loss arrangements. Taking the above into account, the Court found that: (1) at the end of each year, Reserve’s economic position had not changed; (2) risk distribution was not achieved; (3) Reserve was created solely to realize tax benefits; and (4) the agreements with PoolRe were not bona fide insurance agreements. Finally, the Court held that the risk, if any was indeed transferred to Reserve from PoolRe, was *de minimis* (in fact, the Court hinted that there was a failure to produce evidence related to the underlying coinsurance agreements). Because risk distribution was not achieved, the Court concluded that the Reserve arrangement could not constitute insurance for U.S. federal tax purposes.

## Commonly Accepted Notions of Insurance

As a supplement to the first holding on risk distribution, the Court also found that the Reserve arrangement did not constitute insurance in the commonly accepted sense. To reach this ruling the court looked at the following factors: (1) organization, operation and regulation; (2) adequate capitalization; (3) valid and binding policies; (4) reasonableness of premiums; and (5) payment of claims.

*Organization, operation and regulation.* The court found that apart from satisfying the formalities of organization and compliance with legal requirements, Reserve was not operated as an insurance company. The court noted that Reserve had no employees, its directors knew nothing about its operations and policies, it had no activities in Anguilla, and that management was handled entirely by Capstone. Moreover, there was no evidence of due diligence related to the policies Reserve issued and Capstone's feasibility study was not complete when Reserve issued the direct policies for 2008 and 2009. Additionally, the Tax Court found there was no evidence that Reserve evaluated the risks assumed before executing the quota-share policies. The Court seemed to impose a "due diligence" standard wherein purported captive insurance companies must demonstrate that they behave like insurers would with respect to underwriting and pricing products for unrelated parties.

*Adequate capitalization.* The Court held that Reserve was sufficiently capitalized as it met the minimum capitalization requirements of its domicile, Anguilla.

*Valid and binding policies.* The Court held that Reserve's direct written policies contained terms to make them valid and binding insurance. The Court also noted that these were "cookie cutter" policies that in many instances were not reasonably suited to the needs of the insureds. Accordingly, this factor was determined to be neutral.

*Reasonableness of premiums.* For this factor, the Court noted that Reserve's directors always approved the premium amounts recommended by Capstone. Though evidence was produced that indicated the methodology for determining premium amounts, the Court noted that there were a number of factors indicating that the premiums were not reasonable in relation to the risk of loss. For 2007, Peak paid insurance expenses of \$95,828. For 2008, Peak and two affiliates that had no active business operations paid premiums of \$412,089 in addition to the premiums Peak paid for third-party commercial insurance. The Court also noted that seven of the 2008 policies had retroactive dates. In summary, the Court found that the facts did not reflect that Peak had a genuine need for acquiring additional insurance during the relevant tax years and, accordingly, the premiums were determined not to be reasonable.

*Payment of claims.* The Court held that this factor slightly favored Reserve but that evidence relating to payment of claims was not overwhelming.

## CONCLUSION

In summary, *Reserve Mechanical* provides some additional considerations for taxpayers concerned with meeting the risk distribution and commonly accepted notions of insurance standards for captive qualification. Ultimately, it is likely that the IRS will continue to challenge the validity of captive arrangements and the Tax Court will continue to apply the same judicial tests as were applied in *Reserve Mechanical*. As mentioned above, however, each captive arrangement is to be evaluated taking into account the relevant facts and circumstances. ■

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## ENDNOTES

- 1 Section 831(c), which refers to section 816(a), was added by The Pension Funding Act of 2004 (29 U.S.C. 1001) to incorporate pertinent section 816 definitions to specifically apply the definition of an insurance company to property and casualty insurance companies, including captive insurers.
- 2 *Reserve Mechanical, f.k.a. Reserve Casualty Corporation v. Commissioner*, T.C. Memo 2018-86 (June 18, 2018).
- 3 See also *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014); *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255; and *Avrahami v. Commissioner*, 149 T.C. 7 (2017).
- 4 *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).
- 5 *Avrahami v. Commissioner*, 149 T.C. 7 (2017).
- 6 *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-255.
- 7 We note the Tax Court previously invalidated a pooling arrangement in *Avrahami*. The IRS has long disfavored such arrangements and taken the position such arrangements do not successfully achieve risk distribution.
- 8 *The Harper Group v. Commissioner*, 96 T.C. 45, *aff'd*, 979 F.2d 1341 (9th Cir. 1992).



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