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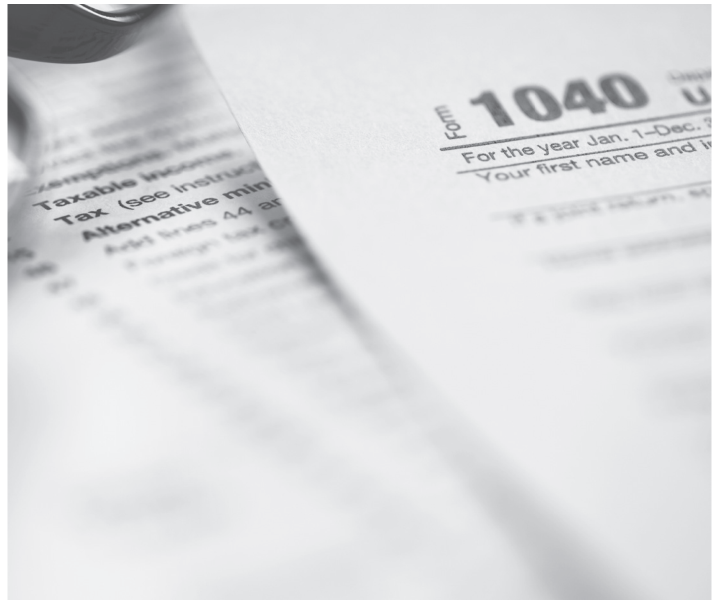
ACLI Update

By Pete Bautz, Mandana Parsazad and Jim Szostek



Regulatory activity earlier this year at the Department of Labor (DOL) and Treasury Department/Internal Revenue Service (IRS) has drawn significant interest from the life insurance industry and resulted in the recent submission by ACLI and its members of several detailed comment letters.

DOL PROPOSED FIDUCIARY RULE

On April 20, 2015, the DOL released a significant, detailed new proposal to change the definition of fiduciary under ERISA. It would apply to recommendations made to: (1) plan sponsors; (2) participants and beneficiaries of welfare benefits and retirement plans; and (3) individuals owning individual retirement accounts (IRAs) and certain medical and education savings accounts. Key aspects of the new proposal raise serious concerns as to whether workers and retirees, as well as small business owners, will continue to enjoy the access they have to financial products and meaningful education and guidance on investments and retirement income. The proposal purports to provide support to existing business models; however, it likely will require significant changes to sales and compensation practices to avoid costly prohibited transactions.

This new proposal is far broader, more comprehensive and voluminous than DOL's 2010 proposal. It includes new and amended Prohibited Transaction Exemptions (PTEs) that, under limited circumstances, permit fiduciaries and their affiliates to receive compensation/revenue. The proposal is justified by an extensive, but flawed, economic analysis. If finalized as proposed, the rule would run counter to the joint initiative—launched in 2009 by the DOL, the Department of Treasury, and IRS—highlighting the importance of guaranteed lifetime income and seeking to address regulatory barriers that prevent greater access to lifetime income products for workers. This rule would be such a barrier.

ACLI filed a lengthy comment letter with the DOL on July 21. The ACLI letter contends that the DOL's proposed regulation regarding the definition of the term "Fiduciary," together with the Department's proposed "Best Interest Contract" Exemption (BICE), and proposed amendments to PTE 84-24, will have a dramatic negative impact on retirement savers' ability to obtain the guidance, products and services they need—including access to guaranteed lifetime income solutions. Additionally, without substantial changes, ACLI expressed serious concerns that, under the proposal, insurers and their distribution partners will no longer be able to engage small business owners to encourage them to establish savings plans for employees, resulting in workers being less likely to save and secure additional guaranteed lifetime income beyond Social Security.

From Aug. 10 to 13, DOL will hold a public hearing on its proposed rule. Following the hearing and the release of the record of the hearing, DOL will reopen the comment period for a limited time. A final DOL rule is expected in the spring of 2016. Prior to that time, ACLI and its members will continue to work with all interested stakeholders to improve the rule.

PROPOSED HEDGE FUND REINSURANCE REGULATIONS

On July 23, ACLI submitted its comment letter to Treasury and IRS on REG-108214-15, the proposed regulations that provide guidance regarding when a foreign insurance company's income is excluded from the definition of "passive income" under section 1297(b)(2)(B) (the "proposed regulations"). In the letter, we also commented on Senator Ron Wyden's Offshore Reinsurance Tax Fairness Act (the "bill") since the bill was introduced during the comment period and was in the public discourse.

Investment income is intrinsic to the life insurance business model and constitutes an active component of the business of a life insurer or reinsurer. The Internal Revenue Code recognizes this by providing a carve-out from the Passive Foreign Investment Company (PFIC) rules for investment income received in the active conduct of an insurance business. Specifically, section 1297(b)(2)(B) excepts from the definition of passive income, income "derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation." The proposed regulations and the bill elaborate on when a foreign insurance company's income satisfies this exception.

Earlier legislative proposals to amend these rules suggested that premiums be a certain percentage of the company's gross revenue to qualify as a company predominantly engaged in an insurance business. We commended Treasury and IRS for not including such a test in the proposed regulations. We noted that Senator Wyden's bill also recognized that there are business reasons why an active insurance company may not meet a formulaic premium to gross revenue test and excluded any such test.

We noted that the approaches for determining whether a life insurance company's investment income is "derived in the active conduct of an insurance business" in the proposed regulations and in Senator Wyden's bill were acceptable. We recommended the use of local reserves as the basis for determining the amount of a life insurance company's assets that should be treated as active under either approach. We wrote that, for life reinsurers, it may be appropriate to use a company's capital as the basis, since they underwrite several products for which the life-insurance-related liabilities are very high. We further recommended that the reserves or liabilities not be modified under either approach. Finally, we stressed the need for Treasury and IRS to provide recourse for life insurance companies to illustrate why they should qualify for the active insurance exception even if they do not meet the numeric guidelines provided in either approach, and stated that such relief should not be temporary.

ACLI expects to continue its dialogue with the Treasury, IRS and Senator Wyden's staff to assure that life insurers are not negatively impacted by any final anti-abuse rule in this area.

NEW NOTIONAL PRINCIPAL CONTRACT REGULATIONS

On July 27, 2015, ACLI submitted a comment letter to the IRS and Treasury regarding final and temporary regulations (T.D. 9719) and proposed regulations (REG-102656-15) published in the Federal Register on May 8 (collectively referred to as the "New Regulations"), relating to the treatment of notional principal contracts (NPCs) with non-periodic payments.

NPCs are financial instruments, such as interest rate swaps, that provide for payments by one party to another at specified intervals, calculated by reference to a specified index on a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts. NPCs typically provide for three types of payments: (i) periodic payments, (ii) nonperiodic payments, and/or (iii) termination payments.

The New Regulations revised Treas. Reg. §1.446-3(g)(4) (the "Prior Regulations") that provided for deemed loan treatment for certain, but not clearly defined, "significant" non-periodic payments with respect to NPCs. The New Regulations simplified the embedded loan rule by eliminating the exception for non-significant, non-periodic payments while creating two new exceptions to the embedded loan rule: for a non-periodic payment made under an NPC with a term of one year or less, and for contracts with non-periodic payments subject to prescribed margin or collateral requirements.

The ACLI letter applauded the government's efforts to draft sensible rules in response to the changing regulatory environment and recommendations from various capital market participants. However, the letter generally agreed with the insightful comments, by letter dated June 18, 2015, submitted on behalf of the North American Tax Committee of the International Swaps and Derivatives Association (ISDA). The ACLI letter specifically requested further clarification or enhancements in the following areas:

- Clarify that the hedge timing rules of Treas. Reg. § 1.446-4 control for the tax treatment of NPCs that are a part of a hedging transaction under Treas. Reg. § 1.1221-2;
- Provide exceptions from deemed loan treatment for NPCs with non-periodic payments and margin collateral that are below certain de minimis threshold dollar amounts;
- Clarify by way of examples how the deemed loan treatment of the New Regulations is to be applied to NPCs other than plain-vanilla interest rate swaps, such as credit default swaps (CDSs) or swaptions;
- Add a carve-out from deemed loan treatment for NPCs that are marked-to-market;
- Permit an NPC to be eligible for the margin or collateral exception if the collateral or margin posted consists not just of cash but of certain high-grade securities; and
- To allow adequate time for implementation, delay the Nov. 5, 2015 effective date of the New Regulations until the later of one year after the date the New Regulations are published in the Federal Register or Jan. 1, 2017.

IRS 2015–2016 PRIORITY GUIDANCE PLAN

In addition to the regulatory activity and comment letters listed above, the IRS on July 31 published its Priority Guidance Plan (PGP, or the "Plan") for the 2015–2016 year. This PGP identifies the priorities for al-

CONTINUED ON PAGE 38

location of IRS and Treasury resources during the 12-month period from July 2015 through June 2016. ACLI is very pleased that at a time when the Plan list is shrinking in size, as evidenced by the year-over-year decrease in total projects from 317 to 277, the IRS has chosen to include the following project on the PGP list: "guidance under §§807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principles-based methodologies, including stochastic reserves based on conditional tail expectation." This expands the project that was included on the last several PGP lists and was described as follows on the 2014–2015 Plan: "guidance clarifying whether the Conditional Tail Expectation Amount computed under AG 43 should be taken into account for purposes of the reserve ratio test under §816(a) and the statutory reserve cap under §807(d)(6)." The expansion of that project in the 2015–2016 Plan to include guidance on issues relating to life principle-based reserving (PBR) has been requested by ACLI for several years, including in its most recent PGP recommendation letter dated April 30. The inclusion of life PBR on this year's project list also was recommended by the American Bar Association Tax Section in its letter dated June 16, 2015. ACLI and its members hope to work closely with the IRS and Treasury in the development of this guidance. ■

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

Mandana Parsazad is senior counsel, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at *mandanaparsazad@acli.com.*

Jim Szostek is vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at *jimszostek@acli.com.*