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Chairperson's Corner PLAY BALL!!!

By Jeffrey Stabach

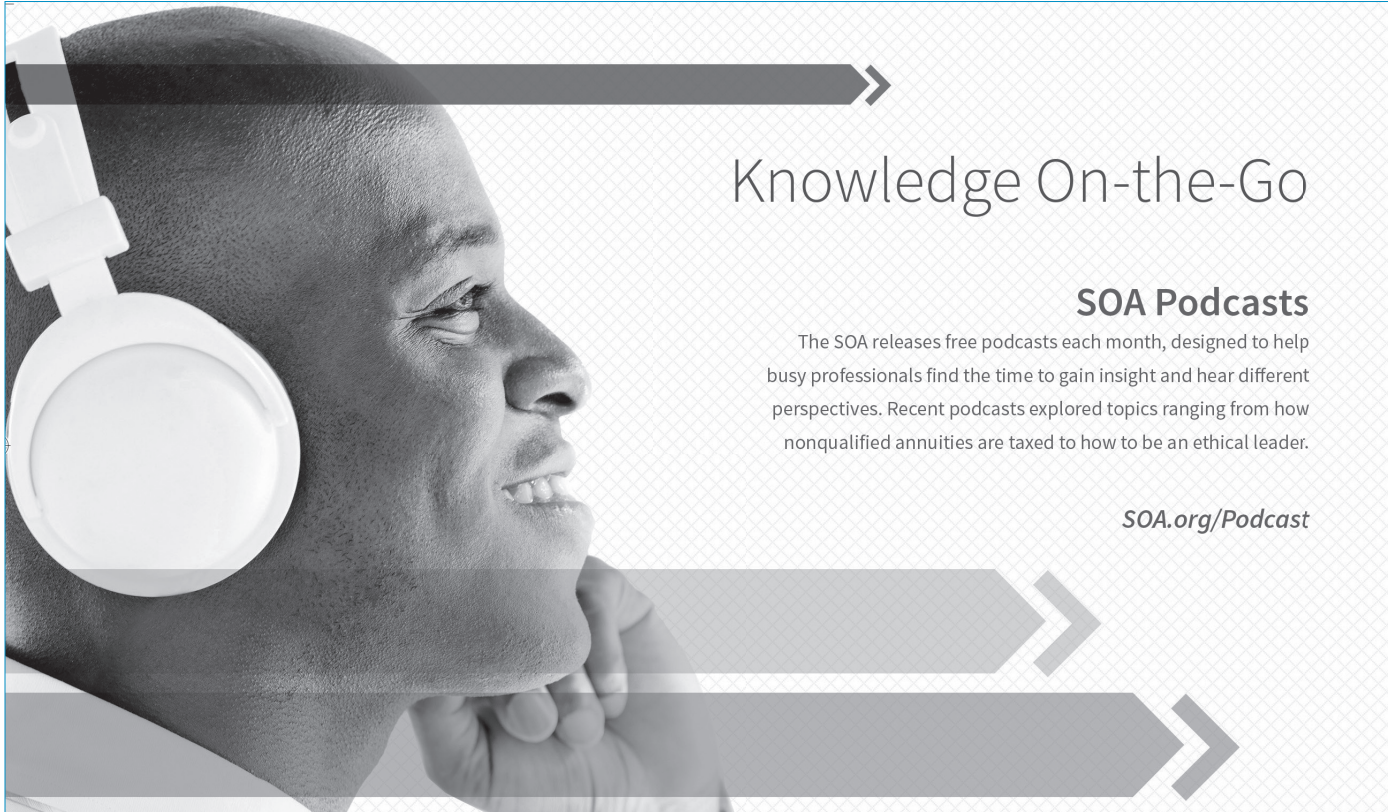
As I write this article in mid-April, I am looking out of my office window and am reminded of two things: (1) that spring is around the corner and (2) that taxes are currently on everyone's mind. The former is mainly visual, in that I am watching them roll sod out on the brand new Hartford Yard Goats baseball stadium (yes, that is their name). The latter, is essentially due to the timing of this article (the IRS filing deadline is only a few days away). With this being a *TAXING TIMES* article, you might say that the second item makes sense, but I'd argue that the first is just as relevant to the Taxation Section. While opening day is just around the corner, it means that there can be a fresh start to the season. In the same way, the industry and the IRS is starting anew with work on the 2017 Commissioner's Standard Ordinary mortality table adoption, Principles Based Reserves (PBR), and the potential for tax reform.

With all these changes on the horizon, we should look for more ways to stay involved and up-to-date on the latest tax content. Here are just a few upcoming events that are full of tax rich content. All are great opportunities for people to learn more or become involved:

- Federal Income Tax Issues Every Company Must Consider Under Life PBR Webinar in June
- Valuation Actuary Symposium in Hollywood, Florida
- 2016 Product Tax Seminar in Washington, DC
- 2016 SOA Annual Meeting & Exhibit in Las Vegas

We are still looking for volunteers for some of these sessions and would love to hear from you if you are interested in learning more about the opportunities. If you're interested, feel free to reach out to me or another member of the Taxation Section Council. Go Goats! ■

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Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part IV: Insurance Tax Accounting Issues

By Peter H. Winslow (Moderator), John T. Adney, Sheryl Flum, Susan Hotine and Mark Smith¹

Note from the Editors:

Welcome to the fourth and final part of a significant journey. At the outset, it was anticipated to be our most ambitious dialogue yet. Our goal was to explore the important and evolving topic of the extent to which the tax law defers to the NAIC in taxing life insurance companies.

Originally anticipated to be a three-part series, it was expanded to four parts due to the breadth of the topics to be covered under “Part III: Insurance Classification Tax Issues” and “Part IV: Insurance Tax Accounting Issues.” “Part I: Tax Reserves” appeared in our June 2015 issue and “Part II: Policyholder Tax Issues” appeared in our October 2015 Issue and “Part III: Insurance Classification Tax Issues” appeared in our March 2016 issue.

We would like to thank our panel of highly experienced tax professionals. Peter Winslow of Scribner, Hall & Thompson developed the concept for this dialogue and volunteered to serve as moderator. Joining Peter was the core group of panelists who participated in each Part of the series: Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the IRS Chief Counsel’s Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman LLP. Susan, John and Peter were all active in the legislative process “In the Beginning”—during the enactment of the Tax Reform Act of 1984. We are also grateful to the other panelists who contributed their expertise: Tim Branch with respect to “Part I: Tax Reserves,” and Brian King with respect to “Part II: Policyholder Tax Issues.”

In this Part IV, the panelists will address legal and accounting questions relating to insurance tax accounting issues, examining issues related to premium income, policyholder dividends, the accounting differences between life and nonlife companies, investment income, and the use of hedges, particularly hedges to offset the cost of variable annuity minimum guaranteed benefits.

We hope you enjoy the conversation!

Peter Winslow: This is the fourth, and final, installment of our extended dialogue on the issue of federal tax law’s deference to insurance regulatory rules. We have covered in some depth the deference issues as they relate to tax reserves, policyholder tax issues, and insurance classification tax issues.² Now we will consider this question: to what extent does NAIC annual statement accounting govern for tax purposes for items other than insurance reserves? In this last dialogue we plan to talk about accounting for income items (premiums, investment income and hedging), as well as other expenses not included in insurance reserves. As in the prior dialogues, I will start with John Adney and Susan Hotine to give us an historical perspective on these issues. John, could you begin this discussion by describing how the 1959 Act and its interpretation dealt with the tax accounting for premiums?

PREMIUM INCOME

John Adney: Peter, “deference” is a good term to use in describing the 1959 Act’s attitude on tax accounting issues for life insurers, and it also fairly characterizes the Code’s approach in dealing with nonlife (part II) companies’ tax accounting both before and after the 1984 enactment. As a general matter, under the 1959 Act premiums reported on a life insurer’s annual statement were included in its gross income,³ overturning the disregard of such amounts under the “net investment income” approach that had been used to tax life insurers since 1921. The great issue in this respect that was resolved in the waning years of the 1959 Act was the extent to which deferred and uncollected premiums⁴ for life insurance were to be taken into account in life insurance reserves, assets, and gross premium income under the tax rules then in place. A diversity of views among five courts of appeals on how this question should be resolved led the Supreme Court to hear the case of *Commissioner v. Standard Life & Accident Insurance Company*.⁵

The principal statutory provision at issue in the *Standard Life* case was section 818(a) as it existed under the 1959 Act; its successor under current law is section 811(a), which is similar, but not identical, to its predecessor. Section 818(a) first required all computations under part I of Subchapter L to be made using an accrual method accounting or, as permitted under regulations, an accrual method combined with another method permitted for income tax purposes (but not the cash receipts and disbursements method). Then, significantly, it added: “Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.”⁶ The relationship of these two sentences was at the heart of *Standard Life* controversy.

The Supreme Court decided that the net amount of the deferred and uncollected premiums, i.e., the premiums net of loading, was to be taken into account in life insurance reserves, assets,

and gross premium income. The court's rationale for recognizing this net amount in reserves was that this treatment had been "the consistent and unbroken practice since the inception of the federal income tax on life insurance companies" and also that this was required in the computation of reserves under state law.⁷ Including the net amount of such "unpaid premiums" in reserves, however, posed the question of how far to carry the "fictional assumption" that the premiums had been paid.⁸ The IRS position was not that the net amount should be excluded from reserves but, rather, that for consistency the unpaid premiums should be included in gross premium income and assets—yet to achieve this consistency, the IRS wanted to include in income and assets the full amount of the premiums, with no reduction for loading. This lack of symmetry troubled the court, but so did the taxpayer's argument that none of such premiums should be included in income and assets, presumably on the ground that accrual accounting would not require it.

To resolve the conflicting views and "decide the scope to be given to a fictional assumption,"⁹ the Supreme Court looked to the second sentence of former section 818(a), invoking the role of the NAIC annual statement. The annual statement accounting for deferred and uncollected premiums, which the court acknowledged had no counterpart in accrual accounting, required the net amount of the premiums to be included in income and assets. Under section 818(a), according to the court's opinion, "rejection of the NAIC approach would be justified only if it were found inconsistent with the dictates of accrual accounting," which the court found not to be the case.¹⁰ The court thus concluded that deference to the NAIC's treatment of the unpaid premiums not only was mandated by the statute but also provided a practical solution to the conundrum.

This was not the end of the story for deferred and uncollected premiums because of a change made by the 1984 Act, but the general guidance provided in the *Standard Life* opinion on the relationship of the accrual method requirement and the role of annual statement accounting under today's section 811(a), at least for insurance reserves, remains valid. A more recent decision involving a part I taxpayer under the 1959 Act that cited to the *Standard Life* formulation is that of *Time Insurance Company v. Commissioner*.¹¹ In that case, the insurer deducted medical insurance claim reserves that were determined by assigned loss "incurred dates" and a claim lag allowance in accordance with state law and NAIC requirements. The Tax Court sustained the deductions over IRS objection, reasoning that the insurer's claim reserve computations following NAIC rules were not inconsistent with accrual accounting because such computations were not recognized in accrual accounting. The court viewed the NAIC rules as controlling in this instance since the Code and regulations were otherwise silent on the matter.

Peter: You are right that *Standard Life* is not the end of the story



for deferred and uncollected premiums. Susan, what is the next chapter in the story? How did Congress address this accounting issue for premiums in the 1984 Act?

Susan Hotine: John is right. Section 811(a) is very much like its predecessor under the 1959 Act, section 818(a). Like its predecessor, section 811(a) generally requires accrual accounting (or, to the extent provided under regulations, a combination of accrual and another accounting method). The difference from its predecessor is in the introductory clause to the flush language that calls for computations to be made in a manner consistent with the requirements of the NAIC annual statement. Whereas old section 818(a) said that accounting should be consistent with annual statement accounting "[e]xcept as provided in the preceding sentence [requiring accrual accounting]," current section 811(a) says the same thing, but "[t]o the extent not inconsistent with the preceding sentence or any other provision of this part." The legislative history explains the purpose of this change as making it clear that accounting methods for state regulatory purposes apply only to the extent they are not inconsistent with Federal tax accounting rules; as reinforcing the primacy of the Federal tax rules and not imposing a new method of accounting on life insurance companies.¹²

Also, with the 1984 Act, a new accounting rule was adopted that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income.¹³ Because deferred and uncollected premiums do not accrue until paid, the reserves related to those premiums may not be recognized until the premiums are taken into income. This effectively reverses the holding of the *Standard Life* case.

To the extent the *Standard Life* case held that in some instances accounting for premium income need not follow standard tax accrual accounting rules, but should be consistent with NAIC annual statement accounting to offset reserve recognition rules, the adoption of section 811(c)(1) eliminates the need for such a conclusion by altering the reserve recognition rules for tax purposes. Thus, the current-law accounting provisions adopted under the 1984 Act have to be interpreted as cutting back on the amount of deference to be shown to NAIC annual statement accounting for tax purposes.

Peter: Is it fair to say, then, that what Congress effectively did in the 1984 Act was to change the accounting for premium income, delinking it from NAIC annual statement accounting, but at the same time carrying over from prior law the deference to annual statement accounting for insurance reserves that the Supreme Court recognized in *Standard Life*?

Instead of continuing a deduction for policyholder dividends based on changes in a policyholder dividends reserve, the 1984 Act adopted a rule allowing a deduction only for policyholder dividends paid or accrued during the taxable year.

Susan: I agree that Congress “delinked” accounting for premium income from NAIC annual statement accounting under the Supreme Court’s analysis in *Standard Life*, but at the same time the specific deference to annual statement accounting for insurance reserves that the court recognized in has been trumped by the rule in section 811(c)(1). Thus, the call for tax computations to be consistent with NAIC annual statement accounting is premised on such consistency not being inconsistent with the general accrual accounting rule “or any other provision” of Part I. I think I would say that Congress carried over from prior law the deference to annual statement accounting for insurance reserves that the Supreme Court recognized in *Standard Life* to the extent it did not adopt specific tax rules or restrictions (e.g., tax reserve rules under section 807(d)), and the computational restriction against reserving for excess interest guaranteed beyond the end of the taxable year under section 811(d)).

POLICYHOLDER DIVIDENDS

Peter: Let’s turn to another accounting issue—policyholder dividends. Where were we on tax accounting for policyholder dividends under prior law?

John: As a general matter, the 1959 Act allowed a deduction for policyholder dividends shown on the annual statement, including the reserve for dividends declared before year-end and payable in the following year.¹⁴ The deduction for the reserved amount departed from accrual accounting precepts, of course, and followed the NAIC statement’s approach. The ability of an insurer to benefit from this deduction varied based on the “phase” in which it was taxed under the 1959 law, but that is another and much more complex story.

Peter: Susan, I think we have another chapter in the story for policyholder dividends too. Will you outline for us the changes made in life insurance company tax accounting by the 1984 Act for policyholder dividends?

Susan: Instead of continuing a deduction for policyholder dividends based on changes in a policyholder dividends reserve, the 1984 Act adopted a rule allowing a deduction only for policyholder dividends paid or accrued during the taxable year.¹⁵ While prior law followed annual statement accounting for policyholder dividends, current law does not. As part of the transition rules of the 1984 Act, companies were given a “fresh start” with respect to the policyholder dividends deduction. That is, the change from reserve accounting to accrual accounting was not treated as a change in method of accounting requiring a section 481 adjustment to eliminate what would result in a double deduction of certain dividend amounts. Interestingly, soon after the enactment of the 1984 Act, Congress became aware of the fact that companies began changing their dividend declaration practices. Instead of declaring a policyholder dividend amount at the end of a year to be payable on policy anniversaries during the following year, companies began guaranteeing policy dividends on termination, or changing the dividend payment date by making the dividends available upon declaration. Because it was viewed that such changes in business practices restored the company in part to the position it enjoyed under prior law, Congress enacted provisions under the Tax Reform Act of 1986 to eliminate what was perceived as a double benefit of accelerating policyholder dividend deductions by a change in business practices and the fresh-start benefit otherwise made available.¹⁶

Sheryl Flum: To be deductible under the current tax standard, life company policyholder dividends must be “paid or accrued” during the taxable year.¹⁷ In two fairly recent cases, the IRS argued that policyholder dividends can’t be deducted in the year immediately preceding the year of payment.¹⁸ In *MassMutual*, the policyholder dividends at issue were guaranteed in the aggregate, and the court allowed the accrual and, thus, the deduction in the earlier tax year. In *New York Life*, the policyholder dividends at issue were either (1) credited in December and paid in January or (2) paid at termination of the life insurance policy; the taxpayer was unsuccessful in convincing the court that accrual had occurred in the earlier tax year.

The taxpayers in *MassMutual* and *New York Life* did **not** argue that statutory accounting treatment for policyholder dividend accruals would control the tax deductibility result. Indeed, both taxpayers agreed with the IRS (or at least did not ultimately contest) that the “all events test” and the economic performance rules would apply to their policyholder dividends deductions. State regulatory treatment was an enhancing—yet not decisive—fact in *MassMutual*, as the Federal Circuit noted that “... *MassMutual* had informed state regulators of these dividends, the state regulators approved the dividends, and there was evidence that the regulators had authority to enforce the dividend guarantees if that were necessary.”¹⁹

So the themes of deference and statutory accounting treatment did not come into play as part of the current life company policyholder dividend controversies—although state regulators’ involvement in the dividend process was acknowledged by the court in *MassMutual*.

ACCOUNTING DIFFERENCES BETWEEN LIFE AND NONLIFE COMPANIES

Peter: John, you commented that deference to the NAIC also describes the Code’s approach to dealing with tax accounting for nonlife or part II companies. How is that the case?

John: As you noted, Peter, in your excellent article on the section 807(d) treatment of stochastic reserves that appears in the last issue of *TAXING TIMES*,²⁰ part II of Subchapter L has been construed by the courts as giving broad deference to the NAIC. Use of the annual statement accounting for items of income and expense of property and casualty insurers is hard-wired into the rules of section 832, a circumstance that long pre-dated the enactments of the 1980s and continues today. Section 832(b)(1)(A) and (6), dealing respectively with the definitions of the gross income and the expenses incurred, expressly require these amounts to be determined for part II companies based on the NAIC annual statement. In cases challenging various loss reserve deductions that adhered to the amounts shown on the insurers’ annual statements, the courts have enforced the statutory requirement. As the Court of Appeals for the Seventh Circuit observed in the *Sears* case, “State insurance commissioners’ preferences about reserves thus are not some intrusion on federal tax policy; using their annual statement is federal tax law.”²¹

Mark Smith: Absolutely true, and that has certainly been the trend in recent litigated cases. In Part I of the dialogue, we talked about several cases in which the IRS unsuccessfully challenged taxpayers’ treatment of various items that for tax purposes were accounted for consistent with the annual statements the companies filed. For example, in the *State Farm* case,²² the Seventh Circuit deferred to annual statement principles to conclude that a taxpayer must include compensatory damages in unpaid losses for purposes of section 832(b)(5). Most recently, in the *Acuity*

case,²³ the Tax Court disagreed with the IRS that a company’s annual statement reserves were too high and should not be used for tax purposes. And, in the *R.V.I.* case,²⁴ the Tax Court relied heavily on the characterization of residual value insurance policies for state regulatory purposes to conclude the policies constituted insurance in the commonly accepted sense.

That is not to say that there is a single overarching theory of deference in these cases. In fact, one could take a different lesson from each. For example, one could reasonably read *State Farm* to defer to the annual statement characterization to determine the character of losses that are included in “unpaid losses.” One could reasonably read the *Acuity* case as primarily involving valuation, and respecting the thoroughness with which the statutory reserves in that case were determined. And, one could reasonably think of the *R.V.I.* case as not involving reserves at all, but rather considering the statutory treatment of an arrangement in order to decide whether the arrangement constituted insurance in the commonly accepted sense. To John’s point and the quote from *Sears*, I think the differences in these cases broaden, rather than narrow, the deference that is inherent in these rules.

Peter: John and Mark, I’m glad you noted the deference to annual statement accounting for nonlife insurance companies, and particularly appreciate John’s kind comment on my article on stochastic reserves. It so happens my “*Can You Believe It?*” column in that same issue of *TAXING TIMES*²⁵ also bears on this question. In that column I point out that nonlife companies essentially get to use annual statement reserve accounting for three items—experience-rated refunds on group insurance, guaranty fund assessments and loss adjustment expenses—and life insurance companies do not. Let’s take these items one at a time and briefly tell our readers why life companies can’t use annual statement accounting for them. John, tell us about experience-rated refunds.

John: As Susan pointed out a little earlier, the 1984 Act abandoned basing the deduction allowed to a life company for policyholder dividends on the change in the annual statement reserve for the dividends. In 1984, Congress opted instead to allow the deduction only for dividends paid or accrued during the taxable year. At the same time, the Act defined policyholder dividends to include experience-rated refunds, which it defined as “any refund or credit based on the experience of the contract or group involved.”²⁶ This broadened the scope of the policyholder dividend definition that had been used under the 1959 law, which referred to the experience of the company and the discretion of management in characterizing an amount as a dividend. Hence, under the tax law today, and without regard to its treatment on the NAIC annual statement, an experience refund is deductible only if it meets the “paid or accrued during the taxable year” standard.

Peter: Mark, what about guaranty fund assessments? Why don't NAIC accounting rules govern for life companies?

Mark: The general rule for guaranty fund assessments under SSAP 35 is that they are charged to expense when an insolvency giving rise to an anticipated assessment takes place. So far, so good.

For tax purposes, the general rule in Subchapter L that begins with the annual statement treatment of an item sometimes yields when a more specific rule in the Code prescribes a different treatment. Several specific tax rules compete in the case of guaranty fund assessments. For example, is the assessment accounted for as a tax? SSAP 35 applies to "taxes, licenses, and fees." For tax purposes, however, the Court of Federal Claims has concluded that the assessments are not taxes within the meaning of section 164.²⁷ Is the assessment required to be capitalized under section 263 of the Code? Regulations under that section²⁸ presume that payments are deductible unless specifically enumerated, and guaranty fund assessments are not so enumerated. Is the assessment deductible before it is paid? Possibly so, if it can be characterized as a reserve or if there is an argument that economic performance occurs before payment. In the *Acuity* case, the IRS originally asserted that the economic performance requirement was not satisfied before payment of a guaranty fund assessment, but the IRS conceded that issue before trial. What about treating it as a reserve? A critical reader will ask whether such an amount can be included in tax reserves where it wasn't accounted for as a reserve for annual statement purposes.

The point here is not that we can resolve the treatment of guaranty fund assessments in this dialogue. Rather, the reader should be aware that several specific tax rules bear on the issue, and as a result the likelihood the IRS or a court would defer to SSAP 35 for guaranty fund assessments is correspondingly diminished. The September 2006 issue of *TAXING TIMES* has a very helpful article discussing the tax accounting for guaranty fund assessments.²⁹

John: Mark, an assessment's treatment as an allowable tax reserve would also depend on the rule in section 811(c)(1). As Susan described earlier, in adding that rule to the Code, Congress made clear that for a reserve to be recognized for tax purposes, the premiums or other consideration funding it must be included in gross income. So, for a reserve deduction to be allowed, it would be necessary to distinguish that rule or else contend that it was somehow satisfied.

Peter: Susan, there is some controversy about the treatment of loss adjustment expenses for life companies. Can you shed some light on this question and explain why the IRS takes the position that life companies can't deduct these types of expenses on a reserve basis as required by annual statement accounting under SSAP No. 55?

Susan: When the 1984 Act was enacted, it was generally understood that loss adjustment expenses (LAE) of life insurance companies were deductible when paid or accrued and could not be deducted on a reserve basis as allowed for nonlife insurance companies under section 832(b)(6). However, with the enactment of the Tax Reform Act of 1986, the provisions to discount unpaid losses under section 846 apply to both life and nonlife insurance companies, except where there are specific tax reserve rules for unpaid losses under section 807(d). The last sentence of flush language of section 807(c) says that, for purposes of determining the reserve for unpaid losses and benefit payments, "the amount of unpaid losses (other than on life insurance contracts) shall be the amount of the discounted unpaid losses as defined in section 846." Under section 846(a), the amount of discounted unpaid losses is based on "undiscounted unpaid losses," which means the unpaid losses shown on the annual statement filed by the company, and which includes any LAE shown on the annual statement.³¹

In explaining discounting of unpaid losses, the legislative history on the discounting of unpaid losses is consistent with the statutory language, saying that LAE are to be treated as unpaid losses (and discounted) and not to be included in the amount of expenses unpaid under section 832(b)(6).³² However, when the Tax Reform Act of 1986 went to conference and the conference committee adopted the Senate's provisions for discounting unpaid losses, the committee clarified that, although life insurance companies were subject to the same unpaid loss discounting rules, life insurance companies "may not deduct loss adjustment expenses that do not meet the all-events test applicable under sec. 461 of the Code."³³ The legislative history continues to explain that it is not intended that noncancellable accident and health business subject to tax reserves rules under section 807(d) be subject to section 846 discounting, and that life insurance companies be permitted to deduct LAE by virtue of the application of section 846 discounting to cancellable accident and health business. Based on this clarification in the Conference Report, the IRS takes the position that life insurance companies cannot include LAE in unpaid losses.

It should be pointed out that, although the Conference Report included this "clarification," the Conference Committee made no changes to the statutory language. By the same token, it can be argued that the statutory language regarding a life company's use of section 846 discounting for unpaid losses and the inclusion of LAE in unpaid losses is not ambiguous on its face. The IRS' reliance on the legislative history might be viewed as inconsistent with the Supreme Court's more recently stated positions that legislative history is relevant only to help construe an ambiguous statute.³⁴

Peter: So, it seems unclear whether LAE is deductible by life companies following NAIC reserve accounting at least for LAE on cancellable A&H products.

INVESTMENT INCOME

Peter: Let's shift gears and talk about investment income and the role of NAIC annual statement accounting. The Code has an interesting special rule that is applicable only to life insurance companies. Section 811(b) says that a life company is entitled to accrue original issue discount (OID) and bond premium in accordance with the method regularly employed by the company if that method is reasonable. This has been interpreted to permit life companies to follow their annual statement accrual method for OID and bond premium and not use the detailed rules for these items generally applicable to other taxpayers. This is usually, but not always, a better answer; it's certainly a simpler approach.

Mark: does this special OID income accrual rule provide authority for the IRS not to require taxpayers to accrue OID on impaired bonds even if there is doubt as to its collection?

Mark: Yes, it does. According to IRS, the OID rules require that a taxpayer continue to accrue Original Issue Discount into income, even when there is doubt as to the collectability of amounts due on the underlying debt.³⁵ This position is particularly harsh, because it requires recognition of income that likely will never be collected. Taxpayers have criticized the position, and it would operate as a particular hardship to insurance companies, which historically hold significant corporate debt. Fortunately, in the case of life insurance companies, the IRS has recognized that section 811(b) deference to "the method regularly employed by the company" provides authority to reach the result that more clearly reflects income in the case of OID accrual on impaired debt. In a 1993 Field Service Advice,³⁶ the National Office advised the team examining a life insurance company that accrual was not required in a situation where the appraised value of the collateral was less than the loan at issue, provided the company established that the statutory accounting treatment was not to accrue.

Peter: Speaking of impaired investments, there have been significant recent developments on the question of deferral to NAIC accounting for bad debts.

Mark: Yes, there have. The tax law allows a deduction for debt that becomes worthless during the year. Regulations provide circumstances where a bank "or other corporation" that is similarly regulated for solvency charges off a debt in whole or in part.³⁷ Under those regulations, a debt is conclusively presumed to be worthless to the extent charged off under established regulatory standards subject to subsequent written regulatory confirmation of the charge-off on audit. The operation of those regulations is straightforward for banks, but in some cases generated controversy for insurance companies. Early on, some examiners, for example, questioned whether the methodology in the regulations applied to insurance companies, or whether the application of SSAP 43R met the regulation's requirements of a charge off, or how much of a charge off was credit-related and therefore deductible.



In response to industry requests and a lengthy dialogue, the IRS issued an Industry Director's Directive³⁸ that set forth the terms and conditions under which this conclusive presumption of worthlessness would apply. For example, the Directive specifically referred to credit-related impairments under SSAP 43R, and provided an entire regime for implementing the regulation, including a consistency requirement, a certification statement, instructions for determining the amount of worthlessness and adjusted basis, and mechanics of a section 481 adjustment.

We would identify this as an example of "deference" in this dialogue, and I think many taxpayers, advisors, and IRS personnel also would think of it as an example of good government. Stat-tax conformity in accounting for worthless or partially worthless debt produces a clear reflection of income and dramatically reduces time-consuming controversies in Examination.

One interesting footnote to this story is that the IRS subsequently published a Notice³⁹ to the effect it was taking a fresh look at the regulation on which the Directive is based. Many in the industry hope the IRS will use the opportunity to make improvements to the regulation, such as expanding the regulations to apply to foreign-regulated companies, and addressing the treatment of post-charge off accretions and recoveries.

Peter: The industry coalition that worked with the IRS on this bad debt Directive has submitted comprehensive recommendations for these regulations to improve the IRS' treatment of impaired assets.

Sheryl: I'm not sure I have such high hopes that the IRS is planning on expanding the application of the regulation. I think the IRS' purpose in reconsidering the regulation has more to do with their reluctance to rely on state regulators. The idea behind allowing regulated companies (i.e., banks and insurance companies) to take a tax deduction for debts their regulator required

them to write off was to ensure that there would be no cash tax expense incurred that would diminish the impact of the write-off. The regulatory concern is consumer protection. Banks and insurance companies need to have liquidity to cover customer needs. The Code, on the other hand, does not generally consider taxpayer liquidity needs. It's possible that the IRS is reconsidering whether to follow statutory accounting in these situations.

HEDGES

Peter: Your discussion of the IDD for bad debts leads us naturally to another important recent IDD dealing with life insurance company hedging for variable annuities. Mark, is there any role for annual statement accounting for hedges in determining the tax liability of life insurance companies? Tell us about the hedging IDD.

Mark: That's a great topic, and possibly the most important subject matter in this whole area of deference in the past ten years.

The tax laws for recognizing gains or losses on the sales and exchanges of assets, and the character of those gains or losses,

The VA hedge IDD carefully threads a very fine needle, and does so with an artful and appropriate deference to statutory accounting.

are complex. In general, gains and losses are recognized for tax purposes when they are "realized" (that is, when the underlying instruments are sold or the position is closed), and capital losses are deductible only to the extent of capital gains, or are carried back or over. If the positions are hedges, the tax law attempts to match the timing and character of gains and losses to the timing of gains and losses relating to the item being hedged.

What happens when a company hedges its obligations to policyholders with respect to guaranteed minimum benefits under variable annuity contracts? What is being hedged, the reference assets or the obligations to policyholders? What is the nature of the gains and losses? Are they capital? Ordinary? When and how should the gains or losses be measured for tax purposes? On a mark-to-market basis? A realization basis? This is an area where the development of products and guarantees outpaced the ability of existing tax guidance to produce sensible answers. After the financial downturn in 2008, many companies were left with enormous

losses on assets that they held, and potentially enormous mismatches in income and deduction as a result of timing and character differences in the accounting for hedges and the reserve deductions that accounted for obligations to policyholders.

Like the process for the IDD for bad debts that we just talked about, the process for the IDD for variable annuity hedging⁴⁰ began with an industry request that the IRS address these issues and provide sensible guidance to clearly reflect income and minimize controversy in Examination. The outcome of that process was an IDD that had several very helpful features: (1) the identification of GMxB obligations and hedges as ordinary; (2) the use of mark-to-market value accounting, based on the mark-to-market valuation that applies for statutory accounting purposes; and (3) a method of accounting for hedge gains and losses that, at least to a degree, attempts to match those gains and losses to the reserves with respect to the company's corresponding obligations under the guarantees. Less helpful was a limitation that the IDD applied only to contracts that were issued before Dec. 31, 2009. A full discussion of the IDD is beyond the scope of our dialogue, but the IDD was the subject of a webinar that was sponsored by the Taxation Section, and also was the subject of a number of thoughtful articles in *TAXING TIMES*.⁴¹

The VA hedge IDD carefully threads a very fine needle, and does so with an artful and appropriate deference to statutory accounting. First, as a matter of valuation, the Directive appropriately looks to mark-to-market values that are assigned for statutory purposes, rather than expend resources trying to discern a different, independent valuation to apply only for tax purposes. Second, as a matter of matching, the Directive references net tax deductions for the guaranteed minimum benefits which, in turn, are a function of the company's tax reserves. To the extent the starting point for determining those tax reserves is statutory reserves, the Directive assigns an important role to statutory accounting (or at least builds on the deference already accorded to CRVM and CARVM). None of this defers to the statutory accounting for the hedge gains and losses directly. Rather, it relies on specific elements of statutory accounting to achieve reasonable timing and character for tax purposes.

Peter: It is true that the VA hedge IDD defers to statutory accounting in several important ways, particularly in the reliance on annual statement valuation of the derivatives, but in general hedging is one area where deference to the annual statement seems less useful. Hedge accounting for annual statement purposes currently requires the hedge to be highly effective,⁴² which is almost impossible to achieve for VA hedges. Yet, tax hedge accounting is required because all that is needed to qualify as a tax hedge is for the derivative to manage risk with respect to an ordinary liability. On the other hand, tax hedge accounting is not available for hedges of capital assets, but hedge accounting is available for statutory purposes for highly effective asset hedges.

Although difficult to achieve for liability hedges, a highly effective hedge is not as difficult for asset hedges. So, both the availability of tax hedge accounting and the tax hedge accounting method frequently do not rely on annual statement accounting.

Mark: Broadly, this might be a lesson of this last part of the dialogue. That is, with a regime that begins in statutory accounting and then asks what more specific tax rules might trump, it is important to step back periodically and ask whether the overall accounting for a particular transaction or class of transactions makes sense, and also ask whether Congress intended that particular item to be based on statutory accounting or generally applicable Code provisions.

Peter: I think an appropriate end to these dialogues would be a summary of what we have collectively learned from our discussion as to the role of regulatory guidance in interpreting the tax law. We have spent hours over the last year and a half discussing this deference issue as it relates to almost every aspect of life insurance company and policyholder taxation and I am going to try the impossible and sum up everything we have discussed on company tax issues in a lightening round of about one minute.

For the classification issues concerning whether the company is taxed as an insurance company, whether the product is considered insurance and whether premiums are subject to the DAC tax, we have all accepted Sheryl's helpful phrase that NAIC and state regulators' classifications are "helpful but not sufficient." An exception to this general observation is the 50 percent-reserve-ratio test that determines whether an insurance company is a life insurance company for tax purposes. There we have a special tax test that does not depend on NAIC or state definitions of a life insurance company, although the test itself does use statutory reserves.

For tax reserves, we have considerably more binding deference. In general, we have discovered that statutory reserves are used as tax reserves, except where the Internal Revenue Code requires that adjustments be made. And, with just a few exceptions (for example, deficiency reserves and interest rates) the required adjustments are based on NAIC guidance (tax reserve method) or majority state requirements (mortality and morbidity assumptions).

The deference issue as it relates to tax accounting for non-reserve items discussed in this fourth part of our dialogue is mixed bag. In general, gain from operations items, such as premiums, policyholder dividends and guaranty fund assessments, are determined on a tax accrual basis, rather than following annual statement accounting. A possible exception to this may be loss adjustment expenses for cancellable health policies. For investment income, statutory accounting generally can apply for OID and bond premium accruals and maybe impairments of some investments, but only those that qualify for bad debt treatment (for example, not corporate bonds) and only if certain procedur-

al hoops are jumped through. Tax hedge accounting stands on its own and is not governed by statutory accounting.

John, are you up to the challenge to sum up in a lightening round in one minute what we have concluded for the deference issues on policyholder tax issues?

John: I've never completed anything in one minute, Peter, but here goes. If deference refers to congressional reliance on state law and state regulatory practices in the application of the tax statutes, that deference is significant but is far from complete in the product tax area. Thus, Congress built section 7702, section 101(f) before it, and later section 7702A on the structure of state regulation, including the requirement that a contract be treated as life insurance under the law of the jurisdiction in which it is issued in order to be eligible for tax treatment as life insurance. Also, the statutes use the concept of a premium, both net and gross, to define the limits of a life insurance contract's permitted investment orientation, but the definition of this premium must be drawn from state law and associated actuarial practice and tradition. At the same time, however, the tax law prescribes its own very specific rules regarding the calculation of the limiting premiums to implement the objective of constraining investment orientation. Further, as Part II of our dialogue discussed, section 7702's use of the term "cash surrender value" has been the subject of on-going tax regulatory guidance even though it is premised on concepts in state law. In the case of annuities, the income tax regulations specifically refer to the customary practice of insurance companies as a defining touchstone. That said, Congress, the courts, and the IRS have all added to this definition, limiting the benefit of tax deferral to contracts that liquidate principal and are owned by or for individuals, and limiting the duration of this benefit following an owner's death.

The tax law interacts with state law governing long-term care insurance and accelerated death benefits in similar fashion. The safe harbor rules for long-term care insurance contracts in section 7702B rely on state law to identify the eligible contracts, but then set forth a number of conditions for entering the harbor. These conditions sometimes reference state law—such as by requiring that the contracts be guaranteed renewable and by "federalizing" an impressive list of consumer protections that appear in the NAIC's model regulation on the subject—and sometimes they impose their own restrictions, such as barring the presence of a cash value and allowing returns of premiums only at death or surrender. And for accelerated death benefits, the tax law accords with state-based rules allowing life insurance death benefits to be paid where the insured is terminally or chronically ill, but it imposes additional requirements to assure, among other things, the existence of the claimed illness.

Peter: You are hopeless, John. That was well over one minute—but worth it. John and Susan, you both have been around since the 1984 Act was enacted. Do you think the evolution of the tax

law over the last 30 years has been consistent with what Congress intended and the insurance industry envisioned in 1984?

Susan: All in all, yes, I think that the tax law has evolved over the last 30 years as Congress intended in 1984. Although some tax lawyers today read the current Part I of Subchapter L as though it were a brand new statute beginning in 1984, this is not the case. For those who are familiar with the provisions of prior law, it is obvious that the vast majority of the statutory language used in current law is the same as that of prior law. Thus, the legislative history of the current provisions reminds us of the rule of statutory construction that provisions of current law that are based on prior law should be interpreted in a manner consistent with prior law, and says specifically “that, in the absence of contrary guidance in the committee reports, the regulations, rulings, and case law under existing [i.e., prior] law may serve as interpretative guides to the new [i.e., current] provisions.”⁴³

The current law provisions adopted in 1984 simplified the tax structure for life insurance companies by eliminating the prior-law three-phase structure and providing a single-phase structure designed by reference to a stock life insurance company to more closely resemble the general structure for corporate income taxation; and the elimination of the three-phase structure eliminated many prior-law tax issues that arose from that structure. The use of reinsurance to manipulate a company’s taxable income was discouraged by the adoption of section 845. Special life insurance company non-economic deductions under prior law were eliminated and the taxable income computation for life insurance companies became more in line with that of non-insurance corporations. Finally, rather than having a company’s tax reserves based on its statutory reserves as under prior law (which allowed an individual company leeway to report smaller or larger reserves depending on its surplus needs as long as the reserves met the regulator’s minimum reserve requirements), specific rules for computing tax reserves not only tend to provide a better economic estimate of the company’s insurance liabilities than what might be reflected as reserves on its annual statement, but also provide more uniformity in the amount of reserves that can be claimed as liabilities for similar insurance benefits by companies.

I think these were all goals for the provisions adopted by Congress in 1984 and were all more or less accomplished. On the other hand, Congress left some things the same. For example, the tax rules for insurance companies continue to be set apart from the rest of the Code in Subchapter L, with general tax rules applicable to non-insurance taxpayers incorporated by cross reference. Also, the current life insurance provisions still refer to annual statement accounting (section 811(a)) and the reserve methods prescribed by the National Association of Insurance Commissioners (section 807(d)(2)). Thus, I have not been surprised when courts have overruled an IRS position that perhaps is based more on general tax principles in favor of a taxpayer

insurance company’s position that is consistent with accounting and reserve principles prescribed by the NAIC. I do not think that such results are inconsistent with what Congress intended in 1984.

John: I not only agree, Susan, but I must marvel at the resiliency of what was done in the 1984 law. Part I of subchapter L as revised in 1984 has endured longer than any of its counterparts enacted in 1909, 1913, 1921, 1942, and 1959. There have been amendments, certainly, such as the technical corrections made in 1986, the 1987 addition of the section 846 AFR to the interest rate used for tax reserves in section 807(d), the advent of the DAC tax in 1990, and the repeal of section 809 and effective elimination of the left-over phase three tax during the last decade. But the basic effort to remove non-economic deductions and generally rationalize the tax treatment of life insurers remains in effect today. Indeed, the only criticism I would offer goes not to the rules enacted in 1984 but to the 1987 amendment, which introduced what in my view is the questionable use of the loss reserve discount rate to determine the deductible amount of life insurance reserves.

On the product tax side, I believe the 1984 enactment of section 7702 has worked as Congress intended it and largely as the industry envisioned. The major surprise to the industry likely resides in the historic drop in interest rates, which has made section 7702 more difficult to live with in view of its four percent and six percent minimum rate assumptions. To be sure, many companies have had to struggle with the administration of this statute in light of compliance system and personnel errors that have resulted in its inadvertent violation, but the IRS has stepped up to put programs in place to enable the cure of these violations. The greater challenge to companies, in my experience, has come with the enactment, in TAMRA in 1988, of the so-called reasonable mortality and expense limitations in section 7702 and of the companion rules of section 7702A rather than with the action Congress took in 1984.

Peter: To sum up what I am hearing, we seem to agree that in general Congress intended in 1984 to retain considerable deference to insurance accounting principles in the tax law, particularly with respect to insurance reserves. And, that deference has worked pretty well and as Congress intended. Although the IRS has frequently resisted this deference where it has perceived a conflict with the general tax law goal to protect the fisc, the IRS’ push back generally has been rebuffed by the courts, most recently in *American Financial*. Mark, can you sum up for us where you think the IRS is currently on this deference issue. Has its thinking evolved since *American Financial*?

Mark: The lack of published guidance since *American Financial* (and, for that matter, since *State Farm, Acuity, Cigna*, and Notice 2010-29) makes it hard to tell exactly where the IRS is on defer-

ence issues as they relate to insurance reserves. I think, though, that it would be incorrect to assume there ever has been a single overall theory of “deference” on the part of the IRS or, for that matter, taxpayers.

Issues come up one at a time, and both the IRS and taxpayers evaluate whether insurance accounting principles control, or whether instead Federal income tax principles should trump, on a case by case basis. That has always been the case. Based on the cases the IRS has lost in the past decade (particularly *American Financial*), it is inevitable that the pendulum would swing in favor of deference. But by no means will that be the product of an evolving, over-arching theory of deference. Rather, it will be the product of an ad hoc, case-specific assessment of one issue at a time based on existing authorities and (hopefully) a priority that whatever position is taken should clearly reflect income.

An interesting test of this will be the IRS approach to Life PBR, guidance on which is included in the current Priority Guidance Plan. I think most of us believe and hope that the IRS will show considerable deference to insurance accounting principles as those provide the clearest reflection of income and the fairest measurement of life insurance reserves. Enough tax issues are implicated that we may very well see the most robust analysis of various issues under section 807 that we’ve seen in many years. It seems to me that the most logical move for the IRS would be to defer to insurance accounting principles to the maximum extent it believes that it can. As discussed in prior dialogues, this would be the most administrable approach and, ultimately, would best reflect income.

Sheryl: As the IRS has not acquiesced in any of the cases they’ve lost regarding deference, it may be a bit of an overstatement to say that the IRS now favors deference even on an issue-by-issue basis. In providing guidance for Life PBR, the IRS could take the same approach used for the implementation of AG 43. That is, they might provide that the net premium reserve portion of VM-20 can be used for federal tax purposes, and remain silent on everything else. Who knows? We’ll probably still be talking about deference in the abstract five years from now.

Peter: Now, John, I would like you to give Congress some advice if it ever gets around to comprehensive tax reform. To what extent should Congress defer to NAIC reserve and accounting rules in amending Subchapter L of the Code for life insurance companies? What is the most important area where the tax law should defer to statutory accounting?

John: I would urge greater deference to the NAIC in the reserve rules of the future in two respects. First, work I have done over the past year examining the rationale underlying the interest rate formula established in the Standard Valuation Law in 1980 has convinced me of the formula’s soundness for use in section 807(d).

That formula was incorporated into the federally prescribed reserve rules in 1984, and it was a mistake to muddy the waters by importing the section 846 rate into the mix. Second, with the advent of principles-based reserves, Congress is being accorded an historic opportunity to accomplish a long-standing goal of tax policy where life insurers are concerned. Where the deterministic or stochastic reserves prevail for a type of contract, those reserves are about as close to economic reserves as can reasonably be achieved today, and so they should be tax deductible reserves.

Peter: With the talent and experience we have on the panel, we could go on for much longer on these issues, but I think I can hear the *Taxing Times* editors screaming that we have already exceeded our page limitation.

I want to sincerely thank our distinguished panelists for their participation in this four-part dialogue. I hope the *TAXING TIMES* readers have found it useful. NAIC annual statement accounting is still alive and well as a guide to life insurance company taxation! But, as Mark notes, maybe only on a case-by-case basis. ■

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END NOTES

- ¹ **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 any author's firm.
- ² Peter Winslow, et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part I: Tax Reserves," *TAXING TIMES*, Vol. 11, Issue 2, at 22 (June 2015); Peter Winslow, et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part II: Policyholder Tax Issues," *TAXING TIMES*, Vol. 11, Issue 3, at 13 (October 2015); Peter Winslow, et al., "Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part III: Insurance Classification Tax Issues," *Taxing Times*, Vol. 12, Issue 1, at 13 (March 2016).
- ³ Former section 809(c)(1).
- ⁴ A deferred premium is an amount due in the future, i.e., between the annual statement (and tax) year-end and the contract anniversary. An uncollected premium is one due but unpaid at year-end, i.e., during a contract's grace period.
- ⁵ 433 U.S. 148 (1977).
- ⁶ The 1984 legislation changed the lead-in phrase of the quoted language to read: "To the extent not inconsistent with the preceding sentence or any other provision of [part I] ..."
- ⁷ 433 U.S. at 157.
- ⁸ *Id.* at 158.
- ⁹ *Id.* at 159.
- ¹⁰ *Id.* at 162.
- ¹¹ 86 T.C. 298 (1986).
- ¹² Staff of the J. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 621 ("1984 Blue Book").
- ¹³ Section 811(c)(1).
- ¹⁴ Former section 811(b).
- ¹⁵ Section 808(c).
- ¹⁶ Section 808(f). See Staff of the J. Comm. on Tax'n, 99th Cong., *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation*, at 83–85.
- ¹⁷ Section 808(c). Compare this with the nonlife policyholder dividend deduction standard, which is "paid or declared." Section 832(c)(11).
- ¹⁸ *Mass. Mut. Life Ins. Co. v. United States*, 782 F.3d 1354 (Fed. Cir. 2015) ("MassMutual") (certain dividends guaranteed in the aggregate held deductible in the year guaranteed rather than the year paid); *N.Y. Life Ins. Co. v. United States*, 724 F.3d 256 (2d Cir. 2013), *cert. denied*, 134 S.Ct. 1938 (Apr. 28, 2014) ("New York Life") (certain policyholder dividends credited in December and paid in January, as well as termination dividends, did not satisfy the all-events test for accrual and, thus, were not deductible in the year credited).
- ¹⁹ 782 F.3d 1354, at 1361.
- ²⁰ Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *TAXING TIMES*, Vol. 12, Issue 1, at 21 (March 2016).
- ²¹ *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 866 (7th Cir. 1992).
- ²² *State Farm Mut. Auto. Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012).
- ²³ *Acuity v. Commissioner*, T.C. Memo 2013-209.
- ²⁴ *R.V.I. Guar. Co., Ltd. v. Commissioner*, 145 T.C. No. 9 (2015).
- ²⁵ Peter H. Winslow, "Subchapter L: Can You Believe It? Change in Tax Status of an Insurance Company—IRS Eliminates Catch-22 Situation," *TAXING TIMES*, Vol. 12, Issue 1, at 53 (March 2016).
- ²⁶ Section 808(b)(4) and (d)(3).
- ²⁷ *Principal Life Ins. Co. v. United States*, 70 Fed. Cl. 144 (2006).
- ²⁸ Treas. Reg. § 1.263(a)-4.
- ²⁹ Peter H. Winslow & Lori J. Jones, "When Are Guaranty Association Assessments Deductible?" *TAXING TIMES*, Vol. 2, Issue 2, at 24 (September 2006).
- ³⁰ Section 846(b)(1).
- ³¹ Section 846(f)(2).
- ³² S. Rep. No. 99-313, at 501 (1986); Staff of the J. Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986* ("1986 Blue Book"), at 602.
- ³³ H.R. Rep. No. 99-841, vol. II, at 361 (1986) (Conf. Rep.); 1986 Blue Book at 614.
- ³⁴ *Carcieri v. Salazar*, 555 U.S. 379, 129 S.Ct. 1058, 1063-64 (2009); *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-254 (1992); Peter H. Winslow, "Loss Adjustment Expenses for Life Insurance Companies," *TAXING TIMES*, Vol. 7, Issue 3, at 40 (September 2011).
- ³⁵ TAM 9538007 (June 13, 1995).
- ³⁶ Field Service Advisory, 1993 WL 1469637 (September 20, 1993).
- ³⁷ Treas. Reg. § 1.166-2(d)(1).
- ³⁸ I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012).
- ³⁹ Notice 2013-35, 2013-24 I.R.B. 1240.
- ⁴⁰ I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies, LB&I-04-0514-0050 (July 17, 2014).
- ⁴¹ For a discussion of the Directive, see Eric Bisighini & Tim Branch, "Variable Annuity Hedging Directive—A Long and Winding Road," *TAXING TIMES*, Vol. 10, Issue 3, at 1 (October 2014).
- ⁴² SSAP No. 86.
- ⁴³ H.R. Rep. No. 98-432, pt. 2, at 1401 (1984); Staff of S. Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984*, at 524 (Comm. Print 1984); 1984 Blue Book at 581.

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In the Beginning ... A Column Devoted to Tax Basics

Taxation of U.S. Owned Foreign Insurance Operations

By Tim Branch

Many U.S. insurance companies have wholly-owned foreign insurance company subsidiaries or branches, and this article is intended to highlight some of the important tax issues related to such foreign insurance operations. The treatment of foreign operations for U.S. tax purposes is complex, and the addition of the insurance component adds to the complexity. This article won't be able to cover all the tax aspects of foreign insurance operations, but will hopefully give the reader an idea of their general treatment for U.S. tax purposes.

Generally, foreign insurance operations of U.S. companies are either branches or Controlled Foreign Corporations ("CFCs").

There are other forms that foreign insurance operation can take, but we'll focus our discussion on the treatment of CFCs in this article. CFCs are generally defined in Code section 957 as a foreign corporation that is more than 50 percent owned by U.S. shareholders¹ (either on a voting power or stock value basis). The "more than 50 percent" test is replaced by "more than 25 percent" in case of certain foreign insurance companies.²

U.S. taxation of foreign owned enterprises, not just insurance operations, is addressed in Subpart F of the Code, which encompasses IRC sections 951 through 965. These sections tell U.S. taxpayers what amounts of U.S. taxable income to include from CFCs, and are intended to address the issue of deferring U.S. taxation on foreign income. Generally, U.S. tax on income from a foreign operation is deferred until it is repatriated to the U.S. parent company. By keeping income in a foreign country, presumably with a lower tax rate than the U.S., a company can defer including the income in their U.S. tax return. Subpart F was enacted in 1962 to prevent U.S. taxpayers from abusing this deferral by requiring current taxation of certain income earned in a CFC.

Subpart F requires U.S. shareholders of CFCs to include certain items in current taxable income, even if the items have not been distributed or repatriated by the CFC. These Subpart F income items include income that has little or no relation to the CFC's country of incorporation, and can be easily moved to another country, such as investment earnings ("passive income"). Subpart F also contains exceptions that are intended to carve out



income items that cannot be easily moved and are related to the CFC's home country, such as production of goods or services. So how do insurance operations fit into the context of Subpart F?

Subpart F income³ includes two main items; 1) insurance income,⁴ and 2) foreign base company income⁵ (FBCI). The FBCI item includes many components, some of which are industry-specific (such as oil-related activities) and others which are more widely applicable such as foreign personal holding company income (FPHCI) and foreign base company sales and services income. We'll look at each of the two main Subpart F income items in greater detail below.

Insurance income, for purposes of Subpart F, includes "any income which (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would... be taxed under Subchapter L of this chapter if such income were the income of a domestic insurance company," subject to certain modifications to Subchapter L. These modifications include eliminating the "small life insurance company" deduction under IRC section 806, and the determination of reserves under IRC section 954(i) which we will discuss later in this article.

There is also a very important exception to the Subpart F definition of insurance income for exempt insurance income⁶ (EII), which is income derived from exempt contracts (as defined in the following sentence) issued by a qualifying insurance company. Very broadly, EII is income derived from life and annuity insurance contracts issued to residents of the CFC's country of domicile (which constitute "exempt contracts") by an insurance company that primarily writes business in that country, but would otherwise qualify as a Subchapter L company in the U.S. If a contract is regulated as a life insurance contract or annuity contract in the CFC's home country, its determination as a life or annuity contract for purposes of sections 953 and 954 can be made without regard to 72(s), 101(f), 817(h), and 7702. The EII provision typically eliminates most of an insurance CFC's Subpart F income from operations, assuming it is primarily operating and insuring risks in its home country.

As mentioned above, FPHCI is a component of FBCI and includes dividends, interest, royalties and rents. So how does this apply to the investment income associated with assets supporting the CFC's insurance reserves? IRC section 954(i)(2) provides special rules for applying the provisions of the FPHCI under IRC section 954(c)(1), whereby qualified insurance income (QII) is excluded from the FPHCI calculation. QII is defined as income of a qualifying insurance company which is received from an unrelated party and derived from the investments supporting up to 110 percent of the reserves described under IRC section 954(i)(4) for life insurance and annuity contracts (or 80 percent of unearned premium, plus discounted loss reserves, plus one-third of premiums earned during the taxable year for

property, casualty or health contracts). Interest earnings in excess of these amounts are included in Subpart F income. Essentially, this exception allows an insurance company to earn the investment income necessary to support the reserves related to its exempt contracts without requiring it to be reported as Subpart F income; investment earnings in excess of what is needed to support the reserves is included in Subpart F income.

IRS section 954(i)(4) defines the methods for determining unearned premium and reserves for purposes of determining EII under IRC section 953(e) and QII under IRC section 954(i)(2). We'll focus on IRC section 954(i)(4)(B) which defines reserves for life insurance and annuity contracts. In general, this section states that reserves are the greater of the contract's net surrender value (as defined in IRC section 807(e)(1)(A)) or the reserve determined in the same manner as it would be if the CFC was subject to Subchapter L with modifications to the interest and mortality assumed. This means the CFC's reserves would need to be recalculated under the CRVM for life insurance contracts or the CARVM for annuity contracts, which was in effect at the issuance of the contract.

The interest rate used in the calculation of the IRC section 954(i) reserve is determined in the same manner as the interest rate used in the Subchapter L calculation (the greater of the applicable Federal interest rate (AFIR) or the prevailing State assumed interest rate (PSAIR)), except the AFIR is replaced by the interest rate for the functional currency of the CFC which is calculated in the same manner as the Federal mid-term rate under IRC section 1274(d), and the PSAIR is replaced by the highest assumed interest rate permitted to be used in determining the foreign statement reserves⁷. This adjustment is to recognize that the CFC is investing in its local capital markets and not necessarily in U.S. investments.

The mortality and morbidity rates used in the calculation of the IRC section 954(i) reserve should "reasonably reflect the current mortality and morbidity risks in the company's or branch's home country,"⁸ instead of the Commissioners' Standard Ordinary table or other tables prescribed for use in the U.S.

Alternatively, the CFC could submit a ruling request to the IRS to use its foreign statement (i.e., local regulatory) reserves (less any catastrophe, deficiency, equalization, or similar reserves) in lieu of recalculating its reserves on a modified Subchapter L basis.⁹ In order to receive a favorable ruling for such a request, the taxpayer must demonstrate that the foreign statement reserves "provide an appropriate means of measuring income."¹⁰ The foreign statement reserves would still be subject to the net surrender value floor.

Obviously, the recalculation of reserves on a modified Subchapter L basis presents administrative and technical difficulties. Ad-

ministratively, the CFC or U.S. parent company will need to maintain, at a minimum, two sets of reserves—one set for foreign regulatory purposes and another set on the modified U.S. tax basis. This can present a challenge for either the foreign or U.S. actuary who has to learn a new reserve regime and correctly code it into a valuation system. Recalculating reserves under a Subchapter L basis can also raise many technical questions which are not addressed in IRS guidance; what does it mean that an interest rate is calculated in the same manner as the federal mid-term rate? Is this interest rate used in the reserve calculation, or is it meant to be the 60 month average of such rates, similar to the AFIR? How are foreign insurance products classified under the U.S. statutory regime? What mortality or morbidity table reasonably reflects local country risks?

Alternatively, U.S. insurance companies may make an election under IRC Section 953(d) to treat a CFC as a domestic corporation, if the CFC meets certain conditions, and reserves would be calculated under Subchapter L without modifications. This election avoids the complexities of the Subpart F treatment described above, and is often made for foreign operations that would not otherwise benefit from deferral of income (i.e., little or no EII or QII).

There are many other details, nuances, cross-references and exceptions contained in Subpart F. This article is merely intended to give a brief overview of some of the issues to consider when dealing with foreign insurance subsidiaries and operation.

Taxation of foreign operations is a complex and much debated area of current tax practice. However, the general idea behind Subpart F is pretty simple; income that is relocated abroad for the sole purpose of avoiding current U.S. taxes should be taxed under Subpart F, and exceptions are made for foreign income

that is actively earned and not moved abroad to avoid current U.S. tax. These exceptions to Subpart F, in particular certain foreign insurance company income, are not taxed until the income is repatriated to the U.S. However, we all know the devil is in the details, and Subpart F is full of details so be careful when considering how to handle foreign insurance subsidiaries! ■

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END NOTES

¹ IRC section 951(b) defines a United States shareholder as “a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.”

² There are special rules that apply to certain captive insurance companies under IRC section 953(c), such as the “Related person insurance income” rules, which are beyond the scope of this article.

³ IRC section 952

⁴ IRC section 953

⁵ IRC section 954

⁶ IRC section 953(e)

⁷ IRC sections 954(i)(5)(A) and 954(i)(5)(B)

⁸ IRC section 954(i)(5)(C)

⁹ This is essentially the same treatment as foreign branches of domestic life insurance companies, provided the foreign country is non-contiguous to the U.S., are allowed to use under IRC section 807(e)(4), with the additional requirement that the reserves do not exceed the net level reserves.

¹⁰ IRC section 954(i)(4)(B)(ii)

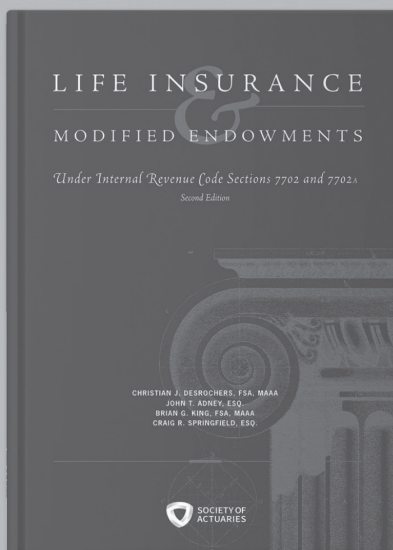


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IRS Issues Guidance on the Separate Account Dividends Received Deduction

By Samuel A. Mitchell and John T. Adney

The Insurance Branch in IRS Chief Counsel's National Office recently issued a Chief Counsel Advice (CCA) memorandum regarding the Dividends Received Deduction (DRD) in the separate account partnership fund context.¹ The CCA provides guidance on a partnership structure that some life insurance companies have adopted for separate accounts in lieu of the more typical Registered Investment Company (RIC) structure. Under the partnership structure, some of the funds in which the separate accounts are invested are taxed as partnerships (instead of RICs) and the life insurance company is a partner.² A few Large Business & International division (LB&I) examiners have raised issues regarding the mechanical application of the company's share/proration calculation as it applies to the partnership structure.

By way of background, the term "proration" generally refers to an allocation of a company's net investment income between the "company's share" and the "policyholders' share." It is based on a fraction that is applied to determine how much of the company's net investment income is credited to policyholders, and how much is not. In this context, the result is applied to the separate account DRD to disallow a portion (representing the policyholders' share) in order to prevent the company from obtaining a double benefit by funding reserve deductions with dividends that have been deducted.

The LB&I examiners, in general, have asserted that in calculating this fraction to be applied to the separate account DRD, the pass-through partnership taxation rules should be disregarded and the proration formula should be calculated as if the partnerships were RIC-like entities. The National Office provided the CCA to an LB&I team in response to a request for advice on three related issues the team raised in an audit of a life insurance company.

In particular, the National Office concluded that the taxpayer under audit by the LB&I team

1. properly determined its gross investment income under section 812(d) without reduction for the investment expenses of the partnership in which the taxpayer invested;



2. properly included in "amount retained" under Treas. Reg. § 1.801-8 the partnership investment fees it paid to an affiliate; and
3. was not precluded from deducting those fees by the section 811(c)(3) prohibition on double deductions.

SEPARATE ACCOUNT DRD BACKGROUND

Some general background might help readers who are not familiar with the separate account DRD understand the CCA's conclusions. Internal Revenue Code section 805(a)(4)(A)³ allows a life insurance company a DRD under sections 243 and 245, but the company must reduce the tax benefit from the deduction under the proration formula (which also applies to tax-exempt interest). In general, the reduction is intended to prevent the company from receiving a double benefit by deducting a portion of the dividends received and also receiving a deduction for reserve increases funded by the dividends.⁴ The reduction is accomplished by allocating, or prorating, net investment income between certain deductible amounts, which generally consist of investment earnings deemed to be credited to policy or contract obligations (the policyholder's share) and amounts not credited (the company's share).

Section 805(a)(4)(A)(ii) permits the DRD only for the "company's share" of the dividends received (other than "100 percent dividends" described in section 805(a)(4)(C)). The company's share is intended to represent the portion of the company's net

investment income on assets that is not considered to be credited to policyholders. The company's share is determined under the proration rules of section 812, and is defined in that section as (1) the taxpayer's net investment income reduced by "policy interest," *i.e.*, interest credited to reserves and similar items, divided by (2) the taxpayer's total net investment income—the result is expressed as a percentage. For the sake of administrative convenience, net investment income is defined for this purpose as a set percentage of gross investment income—90 percent in the case of a company's general account and 95 percent in the case of a separate account.

The determination of the company's share in the separate account context, where each separate account must compute its own company's share,⁵ is significantly more complicated than in the general account context and draws on prior law concepts. As indicated above, "policy interest" for purposes of the proration formula in general is intended to represent the amount of net investment income credited to reserves. Stated differently, policy interest is intended to represent the amount the insurance company has deducted as the interest element in an increase in reserves and it is the share of net investment income allocable to this amount that is intended to be eliminated from the DRD. In the proration formula, the amount credited to reserves is equal to "required interest" plus other items not relevant here.⁶ "Required interest" on reserves for this purpose is determined at the greater of the prevailing state assumed rate (PSAR) or the applicable Federal interest rate (AFR), as required under the reserve deduction rule in section 807(c), or at "another appropriate rate" in a case in which neither the PSAR nor the AFR is used for reserve purposes.⁷ In the case of separate accounts supporting variable products, amounts credited to reserves generally are based on the market value and investment returns of the separate account assets rather than a prescribed interest rate (*i.e.*, rather than the PSAR or AFR). Therefore, in the case of separate accounts, "another appropriate rate" under section 812(b)(2) must be used in order to determine the amount of policyholder interest for proration purposes.

Section 812(b)(2), however, does not define "another appropriate rate" to be used for proration purposes; nor does section 812 provide the specific formula for computing the company's share for separate accounts. This leads to the legislative history underlying section 812 and the other Subchapter L provisions that apply to life insurance companies in the Deficit Reduction Act of 1984 (the 1984 Act).⁸ According to the legislative history of the 1984 Act, the current law provisions generally follow the proration rules for computing gain or loss from operations under prior law, which was the Life Insurance Company Income Tax Act of 1959 (the 1959 Act), and accompanying regulations.⁹ The proration regulations that applied to separate accounts under the 1959 Act are at Treas. Reg. § 1.801-8. These regulations relate to former section 801(g), the predecessor of the separate account rules under section 817 today. Under the regulations,

the company's share in the case of dividends received by a separate account is computed under a formula that is significantly affected by the "amount retained" as defined under Treas. Reg. § 1.801-8(e)(1). In general, the "amount retained" is intended to reflect the amount of net investment income that is not credited to variable contracts, and, therefore, is the key component of the company's share of net investment income.

Thus, in accordance with the 1984 legislative history, the required interest in the separate account case is determined under the prior law rules, including use of a slightly modified version of the formula in Treas. Reg. § 1.801-8(e)(1). Under the formula, the required interest on the separate account reserves is based on the current earnings rates for the separate account (determined under former section 805(b)(2)) reduced by a percentage obtained by dividing (1) "the amount retained by the taxpayer from gross investment income" on the separate account assets in excess of the related investment expense deductions (as defined in former section 804(c)) by (2) the mean of the separate account reserves. In very general terms, the formula effectively

In the case of separate accounts supporting variable products, amounts credited to reserves generally are based on the market value and investment returns of the separate account assets rather than a prescribed interest rate.

eliminates all net investment income that is deemed to be credited to reserves and allocates what is left over to the company's share. The effect of increasing the "amount retained" by including partnership investment expenses is to increase the proportionate amount of separate account investment income that is considered not credited to contracts and thereby increase the company's share percentage, allowing a larger portion of dividends received to be deducted.¹⁰

One simple reason the partnership structure mathematically can result in a larger company's share, and hence, a larger DRD than a typical RIC structure is that RICs are taxed as separate entities and make their distributions net of the type of investment expenses that are passed through in the partnership structure. Similar investment expenses in a typical RIC structure, therefore, do not end up being included in the "amount retained." The LB&I team that requested advice apparently took the position that partnership expenses paid to an affiliate in the partnership structure must not be included in the "amount retained," similar to what would happen in a RIC structure, because the company does not "retain" the amounts in its general account.

FACTS DESCRIBED IN CCA 201603023

As is common with CCAs, CCA 201603023 sets out the operative facts in short form. According to the CCA, the taxpayer/life insurance company issues variable annuity contracts under which certain charges are assessed, such as mortality and expense (M&E) charges. Such charges are paid to the company by a transfer of funds from the separate accounts supporting the contracts to the company's general account, and the transferred amount is reported as income in the general account. The separate accounts, each of which is organized as a unit investment trust and registered as such under the Investment Company Act of 1940, invest in various funds, some of which are organized as partnerships and are assumed in the CCA to be taxed as partnerships. The CCA states that "[w]ith respect to these funds, Taxpayer pays investment expenses to its nonlife affiliate." The nonlife affiliate presumably functions as an investment adviser for the investment partnerships in return for the fees the company pays to it, although the CCA does not say so.

ANALYSIS AND CONCLUSIONS IN THE CCA

The CCA then addresses three specific issues on which it says the LB&I team requested assistance from the National Office. Before exploring the details, the CCA, like predecessor rulings (both published and private (i.e., non-precedential)) relating to the proration rules, acknowledged that the proration "between life insurance company's share and the policyholder's share of net investment income, as provided in § 812, is intended to eliminate the double tax benefit that would arise if the company were allowed to fund deductible reserve increases with tax exempt or tax preferred income."

Issue 1. The first issue dealt with in the CCA involved whether the section 812 proration calculation required the life insurance company to compute the gross investment income of its separate accounts invested in partnership funds net of investment expenses. While not spelled out in the CCA, the investment expenses in question appear to be those of the investment partnerships that were paid to the company's nonlife affiliate.

According to the CCA, the company determined its gross investment income from the separate account's partnership investments under section 812(d) without reducing the amounts by the related investment expenses. On audit the LB&I team apparently contended that the partnership structure should be disregarded and that such gross investment income should be determined net of the investment expenses as it would be in the more typical RIC structure. In a RIC structure the gross investment income determined under subchapter M would consist of the RIC ordinary dividends, net of expenses. The CCA does not detail the LB&I rationale for disregarding the partnership structure but instead points to the general partnership taxation rules under Subchapter K. The CCA notes that "[p]artnerships distribute

The partnership investment fees, regardless of whether they are paid to an affiliate or third party, are not credited to the reserves.

gross investment income to their partners and the partners receive their distributive share of the corporate dividends and a flow-through of their share of partnership investment expenses," citing to section 702(a)(5). Accordingly, the CCA concludes that a "partner that is a life insurance company includes its distributive share of the partnership gross investment income in its gross investment income under § 812(d)," unreduced by investment expenses. The CCA's conclusion, in other words, is that "gross" means "gross," based on the plain language of section 812(d) working in combination with the partnership tax rules.

It is important to understand that the first ruling, standing alone, may not have resulted in a different company's share of the DRD if the expenses were not in turn also included in the "amount retained," which is the subject of issue number two discussed immediately below. The important aspect of the first ruling is that the National Office recognized and respected the flow-through nature of the partnership structure which, ultimately, can result in a higher company's share by inclusion of the partnership expenses in the "amount retained"—i.e., the amount of net investment income that is not credited to the variable contracts.

Issue 2. The CCA next turned to whether including the partnership investment fees in the "amount retained" from interest credited to policyholders was consistent with Treas. Reg. § 1.801-8(e), which the LB&I team contended was not the case. The life insurance company had included these fees, which were paid to its nonlife affiliate, in calculating the amount retained within the meaning of the regulation for purposes of calculating the required interest element of the numerator of the company's share fraction. The CCA concluded that the company was correct in doing so, reasoning that LB&I was incorrect in its effort to exclude from the amount retained calculation the fees paid to the affiliate. (LB&I was willing, according to the CCA, to accept the inclusion of the M&E charges and like amounts transferred from the separate account to the general account in determining the amount retained, but balked at doing so to the extent amounts were paid to the nonlife affiliate.)

The LB&I team apparently contended that amounts paid to an affiliate could not be amounts "retained" by the insurance com-

pany because the amounts did not end up in the general account. This assertion represents a misunderstanding of the purpose underlying the “amount retained” that the CCA helps to clarify although it does not directly explain. As explained above, the objective of the required interest calculation of which the “amount retained” is a part is to determine the amount of the deduction for separate account reserves reflecting amounts credited to policyholders. The partnership investment fees, regardless of whether they are paid to an affiliate or third party, are not credited to the reserves. Stated differently, the “amount retained” is not limited to amounts transferred to the insurance company’s general account, but includes any amount of gross investment income that is not credited to the reserves. Otherwise, under the regulation’s formula, the partnership expenses effectively would be treated as credited to policyholders—clearly not establishing “another appropriate rate” for computing required interest or the policyholder’s share of DRD to be disallowed. Viewed differently, the partnership structure yields a result that is equivalent to the separate account directly owning the underlying assets. The formula recognizes that the fees associated with owning the assets do not belong in the policyholders’ share.

The conclusion that expenses such as investment fees must be included in the “amount retained” becomes even clearer when examining the history of the 1959 Act. The initial 1959 Act provisions with respect to variable annuities were temporary in nature. As first enacted, prior-law section 801(g)(3) contained a special rule for computing required interest under prior-law section 809(a)(2) for reserves based on segregated accounts. The original language provided that the assumed rate of interest for variable annuities was the company’s current earnings rate for variable contracts (determined under prior-law section 805(b)(2)) reduced by a percentage obtained by dividing the amount of the “actuarial margin charge” for all variable annuities by the mean of the reserves. Legislative history defined actuarial margin charges as “general operating charges and other amounts retained by the issuing company pursuant to the terms of the contract to cover actuarial contingencies and to increase surplus.”¹¹ In 1962, the 1959 Act provisions with respect to variable annuities were amended and made permanent.¹² The assumed interest provision mentioned in prior-law section 801(g)(3) was replaced by prior-law section 801(g)(5), and the term “actuarial margin charge” was replaced by the broader concept of “any amount retained ... from gross investment income ...,” to include any investment expenses charged to the separate account in addition to an actuarial margin charge. The regulations were promulgated after the 1962 amendment and picked up this broader “any amount retained” concept.

In rejecting LB&I’s objection, the CCA did not discuss much of the history of the “amount retained,” but focused on the post-1962-amendment regulations that incorporate the broader concept. The CCA observed that the wording of Treas. Reg. § 1.801-8(e) as well as examples appearing in that regulation (which the

CCA summarized in simplified form) showed that inclusion of the investment fees paid to the affiliate in the amount retained was consistent with the regulation. Also, apparently adding support for this conclusion, the CCA’s footnote 16 observed that “[h]istorically, amount retained was the amount the life insurance company held from the gross investment income on all segregated asset accounts to cover general expenses in excess of the expenses provided for in the charges made against premiums to cover actuarial contingencies and increase surplus,” citing to the Senate report on the 1959 Act. The conclusion reached in the CCA is consistent with TAM 200339049, in which the National Office agreed that including a variety of variable contract charges (M&E charges, annual contract maintenance fees, administrative fees, and premium tax charges) in the amount retained was appropriate.

It warrants mention that both LB&I, in stating its objection to the company’s approach, and the National Office in CCA 201603023 accepted the role played by Treas. Reg. § 1.801-8(e) in determining the required interest element of the proration calculation. The use of the modified formula in that regulation, however, has been the subject of considerable controversy in IRS audits of life insurance companies and in published rulings and non-precedential advice issued by the National Office dating at least as far back as TAM 200038008. In 2007, the IRS caused a huge stir in the industry when it issued Rev. Rul. 2007-54, 2007-2 C.B. 604, backing off the holding in TAM 200038008 by concluding in holding number two that life insurance companies must use the applicable federal interest rate rather than “another appropriate rate” in calculating separate account reserves. This holding had a dramatically negative effect on the separate account DRD and surprised the industry. The IRS then issued Rev. Rul. 2007-61, 2007-2 I.R.B. 799, which suspended Rev. Rul. 2007-54 for further study of the issue. After some intense audit controversy over the next three years, LB&I relented in the form of an Industry Directive instructing examiners not to challenge taxpayers who calculated required interest consistently with the TAM.¹³ Then, in 2014, the National Office republished Rev. Rul. 2007-54 in the form of Rev. Rul. 2014-7, 2014-9 I.R.B. 539 (Feb. 4, 2014), in which it officially eliminated holding number two regarding required interest.¹⁴ In footnote 15, the CCA states that it does not express an opinion about the “another appropriate rate” issue, but its analysis and conclusions effectively reject the holding in Rev. Rul. 2007-54.

Issue 3. The rules of part I of Subchapter L (the life insurance company tax provisions) are complex, even apart from the section 812 proration rules described in the first two rulings of the CCA. Reflecting this is the presence of a series of “no double counting” rules in section 811(c). In particular, section 811(c)(3) states that nothing in part I of Subchapter L may be construed to permit “any item to be deducted (either directly or as an increase in reserves) more than once.” LB&I teams have asserted that a

life insurance company taxpayer, by deducting its distributable share of partnership expenses while at the same time including those expenses in the retained amount in the proration formula, is taking a double deduction in violation of section 811(c). The LB&I team that asked for advice made the same assertion.

The CCA rejected the LB&I team’s assertion that the double counting rule applied in the partnership fund context. The CCA explained that while section 811(c)(3) disallows a double deduction for the same item, the dividend for which the company received a DRD is an income item whereas the investment expenses it deducted constitute a general deduction under section 805(a)(8)—hence the two are not the same item. The CCA also noted that LB&I’s contention was inconsistent with proration, since once a life insurance company determined the company’s share of the DRD, “it can use the resulting dividend income to pay deductible expenses or fund its reserves just as it could with any other income.”

CONCLUDING OBSERVATIONS

The conclusions reached in CCA 201603023 constituted a victory of some significance for the taxpayer involved. While these conclusions do not constitute precedent on which other taxpayers can rely, the CCA set out the National Office’s reasons for rejecting the LB&I contentions in a clear and straightforward, albeit succinct, manner. The explanations thus provided for the conclusions should benefit other life insurance companies in comparable situations.

As explained above, the conclusion the CCA reached on issue 1 (inclusion of the gross partnership income in the section 812(d) gross investment income unreduced by the partnership investment expenses) is an important ruling because it respects the flow-through nature of partnership expenses for purposes of the separate account DRD calculation.

The conclusion the CCA reached on issue 2 (inclusion of the partnership investment fees in the amount retained) is the key holding in the CCA for the taxpayer involved, and it makes perfect sense in the context of proration and the supporting background in the 1959 Act and its regulations. The partnership fees were in fact not credited to the policyholders under the variable contracts. Even though they were paid to an affiliate of the company, they clearly did not belong to the policyholders or their share of the earnings. The CCA’s conclusion also was consistent with the view previously taken by the National Office in TAM 200339049, as noted above. As to the conclusion on issue 3 (involving the section 811(c)(3) ban on double deductions), the reasoning of the CCA speaks for itself. Had the theory of LB&I prevailed, the very purpose of the dividends received deduction—mitigation of double taxation of corporate earnings—would have been thwarted. ■

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ENDNOTES

- ¹ CCA 201603023 (July 17, 2015) (Released to the public on Jan. 15, 2016).
- ² A typical partnership fund structure is described in PLR 201527039 (March 19, 2015). Under the structure described in the PLR, a business trust was formed under state law that consisted of a series of segregated portfolios of assets, which were taxed as partnerships. The trust issued shares of each portfolio to support separate accounts and were available only to life insurance companies, either directly or through separate accounts.
- ³ References to “section” refer to the Internal Revenue Code of 1986 unless otherwise indicated.
- ⁴ See generally TAM 9246001 (Oct. 30, 1991), discussing legislative history.
- ⁵ See section 805(a)(4)(D)(iii), (iv) and section 817(c).
- ⁶ See section 812(b)(2). The other items are the deductible portion of excess interest and the deductible amounts credited to policyholder funds under pension plans other than for retired employees, deferred annuities before the deferred annuity starting date, and amounts left on deposit.
- ⁷ See section 812(b)(2)(A), cross-referencing section 807(c), and the flush language at the end of section 812(b)(2).
- ⁸ See TAM 200038008 (June 13, 2000) (discussing legislative history); TAM 200339049 (Aug. 20, 2002) (discussing legislative history).
- ⁹ See H.R. Rep. No. 98-432, pt. 2, at 1430 (1984); S. Prt. No. 98-169, vol. I, at 557 (1984). See also Staff of Jt. Comm. on Tax’n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 623 (1984).
- ¹⁰ The leading tax-actuarial treatise expresses the modified formula for determining the company share in simplified form as follows:

$$\text{Company's Share} = \left[1 - \frac{\text{Mean of Reserves}}{\text{Mean of Assets}} \right] + \left[\frac{\text{Amount Retained}}{\text{Net Investment Income}} \right]$$

Where Net Investment Income is equal to 95% of Gross Investment Income

Edward Robbins and Richard Bush, *Tax Basis of Assets and Liabilities of U.S. Life Insurers*, 215 (ACTEX Publications 2014); see also *id.* at 211, Table 8.1, for a more detailed representation of the formula. The reader can see graphically that this formula effectively allocates amounts not deemed to be credited to reserves to the company’s share.

- ¹¹ S. Rep. No. 86-291, at 43 (1959).
- ¹² Pub. L. No. 87-858, § 3(a) (Oct. 23, 1962).
- ¹³ *Examination of Dividends Received Deduction on Separate Accounts of Life Insurance Companies*, LMSB-4-0510-015 (May 20, 2010).
- ¹⁴ See Susan J. Hotine, “Do We Finally Have Guidance on Separate Account DRD?” *TAXING TIMES*, Vol. 10, Issue 2, at 28 (May 2014).



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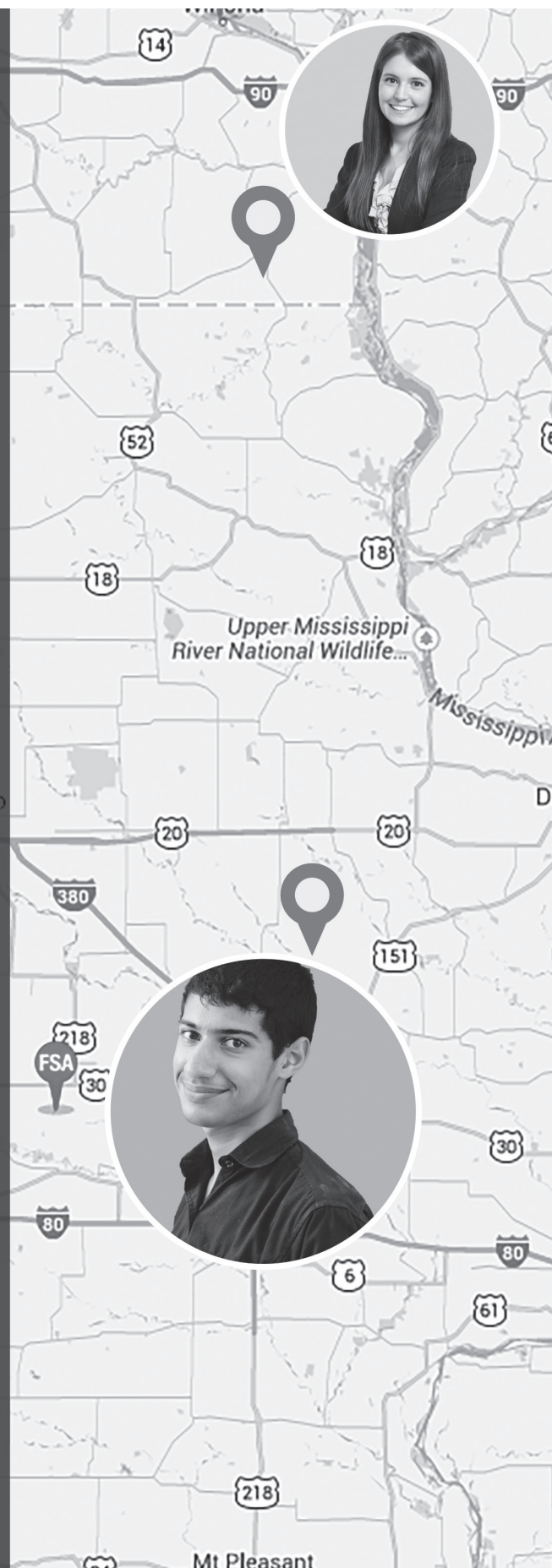
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VM-20 Deterministic Reserves in Federally Prescribed Reserves

By Peter H. Winslow

The March 2016 edition of *TAXING TIMES* contained this author's article¹ that presented actuarial and legal analysis to support the conclusion that the stochastic components of Actuarial Guideline 43 and VM-20 principle-based reserves (VM-20 or PBR) are, and will be, properly included in federally prescribed reserves under I.R.C. § 807(d). In that article, I left consideration of the deterministic gross premium reserve component of PBR (Section 4 of VM-20) for another day. That day has come.

Much of the legal analysis in my article relating to stochastic reserves applies equally to the deterministic reserve component of VM-20. Two points in that article need to be reemphasized as we consider the deterministic reserve component of VM-20. The first important point is that the plain language of I.R.C. § 807(d)(3) requires the deterministic reserve to be taken into account as part of the VM-20 tax reserve method. Federally prescribed reserves must be computed using CRVM as prescribed by the NAIC. Because the deterministic reserve is an integral part of NAIC-prescribed CRVM, it cannot be ignored in the tax reserve computation. Statements found in the legislative history that some have interpreted to suggest that CRVM for tax purposes must be interpreted to have an 1984-era meaning cannot override the clear statutory language that requires post-1984 NAIC changes to CRVM to be the updated tax reserve method for newly issued contracts.

The second point made in my prior article is that a CRVM provision in a reserve for moderately adverse conditions does not mean that a portion of the reserve can be considered a non-deductible "surplus reserve." Most NAIC-prescribed reserves deductible as federally prescribed reserves incorporate prudent assumptions, and the deterministic reserve contains prudent assumptions in the same sense as other in deductible CRVM reserves. Rather than rehash these points in more detail, this article will focus on two other matters. First, I will debunk a myth: gross premium reserves are not included in deductible life insurance reserves because only net premium reserves qualify. In fact, I will point out how several other types of gross premium reserves are taken into account in federally prescribed reserves.

After that, I will offer suggestions as to how to incorporate the VM-20 deterministic reserve in federally prescribed reserves.

IRS NOTICE 2008-18

Several arguments have emerged to support the contention that gross premium reserves cannot be deducted. Some of these arguments are suggested in Notice 2008-18,² and others have been raised informally by IRS personnel and other tax professionals, but the IRS has never issued formal guidance on how or whether gross premium reserves are taken into account in federally prescribed reserves under I.R.C. § 807(d). In general, the objections to gross premium reserves fall into three categories: (1) the reserve may include a nondeductible provision for unaccrued expenses; (2) the reserve fails to satisfy prescribed computational requirements for life insurance reserves in I.R.C. § 816(b); and (3) the reserve may contain nondeductible deficiency reserves. Upon examination, none of these objections bears up well to scrutiny to deny a tax reserve deduction for most gross premium reserves, and particularly not for the deterministic component of VM-20. Let's examine these objections one at a time.

RESERVE FOR EXPENSES

One commonly expressed concern with qualification of gross premium reserves for a tax reserve deduction is that they take into account expenses. Treasury regulations provide that reserves for unaccrued expenses are not deductible insurance reserves.³ These regulations are derived from the seminal Supreme Court case of *Maryland Casualty Co. v. United States*,⁴ from which the definition of life insurance reserves in I.R.C. § 816(b) was developed. In Notice 2008-18, the IRS questioned whether the deterministic reserve component of VM-20 implicitly includes a provision for ordinary business expenses and, therefore, does not qualify in whole or in part as an insurance reserve.⁵ My March 2016 *TAXING TIMES* article explained in some detail why the stochastic component of VM-20 does not include a reserve for future expenses. The same considerations apply equally to the deterministic reserve component of VM-20. In short, the inclusion of future expenses in VM-20 is comparable to the "loading" factor implicit in net premium reserves, *i.e.*, the difference between the gross premium and the valuation net premium. Future gross premiums less future estimated expenses in the gross premium reserve formula are the actuarial corollary to net premiums in a net premium reserve. That is, gross premiums less expenses can be considered net premiums, just as net premiums in a traditional net premium reserve method are net of loading for assumed expenses (and profit). Consideration of expenses in gross premium reserves, therefore, does not mean that a portion of the reserve is held for extra-contractual ordinary business expenses within the meaning of Treas. Reg. § 1.801-4(e).

In analyzing this issue it is important to make a distinction between two types of reserves, both of which may be simplistically

labeled “gross premium reserves”: (1) gross unearned premium reserves, and (2) gross premium reserves that use gross premiums instead of net premiums as the funding source for future benefits. These two are very different reserves actuarially and, as a result, require different tax analysis.

The first type of “gross premium reserve” is a reserve held for the unexpired term of the policy and is computed as the unearned portion of the gross premium paid at the beginning of the policy period. This type of gross premium reserve uses previously-received unearned gross premiums as a surrogate for the value of future contract benefits in the reserve formula. To the extent the prudently estimated value of future benefits is less than the value of unearned gross premiums, the reserve could be considered to include an implicit provision for future expenses (*i.e.*, what would otherwise be the ignored loading portion of the premium in a net premium reserve).

This can be illustrated by the case of *Union Mutual Life Ins. Co. v. United States*.⁶ In that case, the district court held that gross unearned premium reserves for term life insurance contracts were not life insurance reserves because they exceeded net unearned premium reserves computed on the basis of recognized mortality tables and assumed rates of interest. The court determined as a factual matter that the company’s gross unearned premium reserves implicitly included a reserve for expenses. The court did not say that gross premiums can never be used in a life insurance reserve calculation if the reserve otherwise satisfies the computational requirements of what is now I.R.C. § 816(b). In fact, in a subsequent case, *Central National Life Ins. Co. v. United States*,⁷ the Court of Claims held that gross unearned premium reserves qualified as life insurance reserves because they were a reasonable estimate of reserves computed using a recognized mortality table and assumed rate of interest. In the *Central National* case, there was no implicit reserve for expenses.

There is an important distinction between a gross unearned premium method that uses previously-received undiscounted gross premiums and a gross premium reserve methodology, such as the deterministic reserve in VM-20, that uses the present value of future gross premiums less estimated future expenses in lieu of hypothetical net premiums to measure the reduction in reserves for revenue available to fund benefits. There is no reason why this second type of gross premium reserve should be deemed to include a nondeductible reserve for expenses. Unlike a gross unearned premium reserve, the deterministic reserve component of VM-20 will rarely exceed the present value of future benefits and, therefore, would not include an implicit reserve for expenses as in the *Union Mutual* case.

I.R.C. § 816(B) COMPUTATIONAL ISSUES

Notice 2008-18 also cites Rev. Rul. 77-451,⁸ which held that gross premium reserves do not qualify as life insurance reserves



under former I.R.C. § 801(b), the predecessor of I.R.C. § 816(b). The rationale for the conclusion stated in Rev. Rul. 77-451 was of questionable merit even when it was published. The facts in the ruling state that the gross premium reserve was computed using a recognized mortality table and an assumed rate of interest. These facts demonstrate that the reserve actually did satisfy the computational requirements of a life insurance reserve in what is now I.R.C. § 816(b). Despite this, Rev. Rul. 77-451 concluded that there is an additional computational requirement implicit in the need to use a recognized mortality table and an assumed rate of interest. That additional requirement, according to the ruling, is that the reserve method must yield a single unique amount whether it is computed retrospectively or prospectively, which can be achieved only by using a traditional net premium reserve method. This additional computational requirement of Rev. Rul. 77-451—that a life insurance reserve must be computed in such a way that the same reserve amount can be derived whether computed prospectively or retrospectively—was entirely new. It was not found in any case law prior to the ruling, nor has any subsequent court adopted the ruling’s position.

In any event, in today’s world, it would be unreasonable for the IRS to rely on the rationale of Rev. Rul. 77-451 to conclude that gross premium reserves do not qualify as life insurance reserves. Several net premium valuation methods prescribed by the NAIC, and required for use as the tax reserve method under I.R.C. § 807(d), would now fail the ruling’s test that retrospective reserves must equal prospective reserves. For example,

under the rationale of Rev. Rul. 77-451, CARVM reserves for variable annuities would not qualify as life insurance reserves. It would be surprising if the IRS were to attempt to superimpose the outmoded theory of Rev. Rul. 77-451 as a requirement for federally prescribed reserves.

It has been suggested that a gross premium reserve may not be deductible because the list of allowable insurance reserves in I.R.C. § 807(c)(1) includes “life insurance reserves (as defined in section 816(b).” Because I.R.C. § 816(b) contains computational requirements for life insurance reserves that may not be satisfied by gross premium reserves, the argument goes, they are not covered in the list of deductible reserve items.

That is, the cross-reference in I.R.C. § 807(c)(1) is an identification of the type of contract ... it is I.R.C. § 807(d), not I.R.C. § 816(b), that specifies the computational requirements ...

This is a misunderstanding of the meaning of the cross-reference to I.R.C. § 816(b). The purpose of the cross-reference is to identify the types of reserves that are classified as life insurance reserves and required to be subject to the tax reserve computational rules for life insurance reserves in I.R.C. § 807(d). Thus, properly read, the cross-reference means that reserves “which are set aside to mature or liquidate ... future unaccrued claims arising from life insurance, annuity and noncancellable accident and health insurance contracts ... involving, at the time with respect to which the reserve is computed, life, accident or health contingencies”⁹ will be classified as life insurance reserves. That is, the cross-reference in I.R.C. § 807(c)(1) is an identification of the type of contract for which the reserve is held, and a specification of the purpose for which the reserve is held, not a computational requirement; it is I.R.C. § 807(d), not I.R.C. § 816(b), that specifies the computational requirements for life insurance reserves.

The legislative history confirms this interpretation:

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves “as defined in section 816(a).” Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended

merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in prior law required proper computation under State law in order for deductions to be allowed, because prior law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The Act, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves. Thus, a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the Federally prescribed reserve computation, and for example claim treatment as unearned premiums, in order to use statutory reserve amounts for tax purposes.

This quote from the legislative history also highlights the inappropriate consequences of an overly broad reading of I.R.C. § 807(c)(1)’s cross-reference to I.R.C. § 816(b). If a reserve for policy benefits fails to qualify as a life insurance reserve, it would still be deductible as an insurance reserve, probably as an unearned premium reserve under I.R.C. § 807(c)(2). The circumstances in Rev. Rul. 77-451 are a good illustration of the type of situation this legislative history was addressing.

Rev. Rul. 77-451 did not conclude that gross premium reserves fail to qualify as deductible insurance reserves. Instead, as the General Counsel Memorandum¹⁰ underlying the ruling makes clear, the ruling merely concluded that the gross premium reserve at issue was not computed or estimated on the basis of recognized mortality tables and assumed rates of interest. The effect of this conclusion under pre-1984 Tax Act law was that the reserve could not be taken into account as a life insurance reserve in taxable investment income—so-called Phase I. What is not explicitly stated in the ruling, but was clear to tax practitioners at the time, is that the gross premium reserve in the ruling was still deductible as an insurance reserve in gain from operations—so-called Phase II. In fact, in this author’s experience, gross premium reserves were routinely allowable as deductible insurance reserves by the IRS (usually as unearned premium reserves under the predecessor of I.R.C. § 807(c)(2)). The 1984 Tax Act eliminated the Phase I taxable investment income provisions from Subchapter L of the Code and based current law on Phase II gain from operations. As a result, a tax reserve deduction is available if statutory gross premium reserves are held similar to those in Rev. Rul. 77-451, but adjustments would be required by I.R.C. § 807(d).

A related argument sometimes offered is that I.R.C. § 807(d) implicitly prevents a tax reserve deduction for gross premium reserves because it requires the use of specified mortality and interest assumptions that contemplate that statutory reserves that qualify for a tax reserve deduction must use a net premium reserve methodology. There are many problems with this argument. The most important is that the plain language of the statute requires use of the NAIC-prescribed reserve method for the contract as the tax reserve method under I.R.C. § 807(d)(3) without limitation as to how that reserve is initially computed. Basic rules of statutory construction do not permit a perceived congressional intent based on an implied meaning derived from other statutory language to trump unambiguous provisions of the law that in this case defer to the NAIC-prescribed method to determine federally prescribed reserves. In addition, I.R.C. § 807(d) itself recognizes that in appropriate circumstances gross premium reserves are deductible as life insurance reserves. Gross premium reserves reported on the annual statement would be deductible, for example, if they were held for qualified supplemental benefits.¹¹ In any event, the argument that gross premium reserves are not deductible because they do not use mortality and interest rate assumptions does not even apply to the deterministic reserve component of VM-20; it has these characteristics and is capable of being recomputed for tax purposes under the provisions of I.R.C. § 807(d).

DEFICIENCY RESERVES

Notice 2008-18 expresses a concern that the deterministic reserve component of VM-20 may include a nondeductible deficiency reserve. As in the case of gross premium reserves, there are two types of reserves commonly referred to as “premium deficiency reserves.” The first type of premium deficiency reserve most often arises in health and property/casualty insurance and is an aggregate reserve held when anticipated losses and expenses exceed the unearned premium reserve and the contract reserves plus future contract premiums.¹² The IRS’s position is that this type of premium deficiency reserve is not deductible because it is not an unearned premium reserve and is not a reserve for unaccrued claims.¹³ In the case of long-term care insurance, this type of premium deficiency reserve would not be included in federally prescribed reserves because it would not be part of the one-year full preliminary term tax reserve method under I.R.C. § 807(d)(3).

The second type of premium deficiency reserve is what is more relevant to VM-20—the deficiency reserve described in I.R.C. § 807(d)(3)(C). This type of deficiency reserve arises as a result of a net premium method; it is established upon issuance of the contract and amortizes down to zero at the end of the premium-paying period. Only this technical definition of deficiency reserve was disallowed as a deduction under pre-1984 law.¹⁴

Because neither the deterministic nor stochastic reserve in VM-20 is determined using a net premium reserve method, there is nothing in the reserve methodology that compares to a deficiency reserve. Nevertheless, it has been suggested that I.R.C. § 807(d)(3)(C) provides a tax reserve disallowance for something beyond technical deficiency reserves. I.R.C. § 807(d)(3)(C) provides as follows:

No additional reserve deduction allowed for deficiency reserves. Nothing in any reserve method described under this paragraph shall permit any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit.

This section of the Code was intended to maintain pre-1984 tax law and disallow a tax deduction for only technical deficiency reserves. The legislative history reflects this congressional intent. Prior to the enactment of the 1984 Tax Act, former I.R.C. § 801(b)(4) provided that life insurance reserves did not include deficiency reserves. A deficiency reserve was defined in the Code in traditional actuarial terms as follows:

[An amount] equal to the amount (if any) by which –

- (A) the present value of the future net premiums required for such contract, exceeds
- (B) the present value of the future actual premiums and consideration charged for such contract.¹⁵

The pre-1984 Code’s definition of deficiency reserves created an issue because in 1976 the NAIC amended the Standard Valuation Law (SVL) to remove an explicit reference to deficiency reserves. Instead, under the 1976 amendment, if future gross premiums for a policy were less than future net premiums, CRVM reserves were required to be computed by substituting the gross premium for net premiums in the reserve calculation. After the amendment, minimum CRVM reserves were defined as the greater of (a) or (b), as follows:

- (a) the reserve calculated according to the method, mortality table, and interest rate actually used for the policy, and
- (b) the reserve calculated by the method actually used for the policy, but using the minimum valuation standards of mortality and interest, and replacing the valuation net premium by the actual gross premium in each year that the actual gross premium is less than the valuation net premium.

After New York adopted the 1976 NAIC amendment, the question arose for life insurance companies doing business in New York whether deductible tax reserves continued to exclude deficiency reserves. Some taxpayers argued that there no longer were deficiency reserves because the gross premium was actually

the same as the net premium under the 1976 NAIC amendment. The IRS disagreed and issued a private letter ruling holding that, despite the changes in the SVL, a portion of the reserve was still a deficiency reserve.¹⁶

In the 1984 Tax Act, Congress wanted to resolve the issue raised in PLR 8117033. Under I.R.C. § 807(d)(3), Congress adopted the CRVM as prescribed by the NAIC as the tax reserve method, but CRVM incorporated deficiency reserves. To ensure that prior law, as interpreted by the IRS, continued under the 1984 Tax Act, Congress enacted I.R.C. § 807(d)(3)(C) to require that the NAIC's reserve method be adjusted to eliminate any "increase in the reserves" because the net premium exceeds the actual gross premium.

The legislative history indicates that I.R.C. § 807(d)(3)(C) was only intended to disallow technical deficiency reserves as interpreted by the IRS in PLR 8117033. The Blue Book states as follows:

The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under prior law or whether the NAIC prescribed method otherwise requires a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).¹⁷

As the legislative history states, the purpose of I.R.C. § 807(d)(3)(C) was to clarify that deficiency reserves continue to be nondeductible regardless of the NAIC's prescribed method incorporating deficiency reserves in the CRVM calculation.

The intent of Congress to merely disallow a deduction for technical deficiency reserves was reconfirmed in the legislative history of the Tax Reform Act of 1986.¹⁸ Section 1821(l) of the 1986 Tax Act added I.R.C. § 816(h) as a technical correction to the 1984 Tax Act amendments to Subchapter L. The purpose of the technical correction was to make it clear that the change in the statutory provisions dealing with deficiency reserves (including pre-1986 I.R.C. § 807(d)(3)(C)) was not intended to reflect a change in prior law. The Senate Finance Committee Report states as follows:

Present Law

Because of a general change in State law, as well as new rules for computing tax reserves, a prior law provision that specifically excluded deficiency reserves from the defini-

tion of life insurance reserves and total reserves was eliminated. Instead, the present law rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency [sic] reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.

Explanation of Provision

The bill reinstates the prior-law exclusion of deficiency reserves from the definition of life insurance reserves and total reserves for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign life insurance companies doing business in the United States. The exclusion of deficiency reserves under DE-FRA was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies.¹⁹

The legislative history of the 1984 Tax Act also states that where the concepts of prior law are carried over (such as the disallowance of deficiency reserves), the interpretation under pre-1984 Tax Act law should continue to apply. The committee reports state:

Relationship to the 1959 Act

Although the bill amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entire new Part I of subchapter L, the committee intends that the provisions of the new Part I which are based on present law be interpreted in a manner consistent with present law. Thus, where provisions of existing law are incorporated in the bill, the committee expects- that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions.²⁰

Despite this legislative history, it is arguable that, to comply with I.R.C. § 807(d)(3)(C), VM-20 reserves must be reduced for tax purposes if the present value of future net premiums taken into account in the tax-adjusted net premium reserve component of VM-20 exceeds the present value of future gross premiums.

Another potential deficiency reserve issue could arise under Section 6.B.2. of VM-20. A group of certain types of policies will pass the deterministic reserve exclusion test under this section if the company demonstrates that the sum of the valuation net premiums for all future years is less than the sum of the corresponding guaranteed gross premiums for the group of policies. It could be argued that the deterministic reserve component of



VM-20 for any group of policies that has such reserve solely because it flunked the exclusion test is an increase in reserves because the net premium exceeds the gross premiums within the meaning of I.R.C. § 807(d)(3)(C).²¹ This argument has a logical inconsistency, however. It would mean that the deterministic reserve components for some policies are insurance reserves properly taken into account in federally prescribed reserves, while similarly computed reserves for other policies are disallowed.

Later in this article I offer an option to comply with I.R.C. § 807(d) for VM-20 that avoids a need to resolve whether the scope of I.R.C. § 807(d)(3)(C) extends beyond technical deficiency reserves.

RECOMPUTATION OF GROSS PREMIUM RESERVES AS TAX RESERVES

It is demonstrably incorrect to say that when gross premium reserves are reported as statutory reserves no tax reserve deduction is available. In general, life insurance companies are accrual basis taxpayers, which for most taxpayers would mean that a reserve deduction is not allowable. However, I.R.C. § 811(a) provides that computations shall be made in a manner required for purposes of the NAIC annual statement to the extent not inconsistent with accrual accounting or other provisions of Part 1 of Subchapter L, which are the provisions of the Internal Revenue Code that relate to life insurance company taxation. This has been interpreted by the Supreme Court to mean that NAIC annual statement accounting principles apply to insurance reserves because concepts of tax accrual accounting do not apply.²²

Therefore, under I.R.C. § 811(a) a gross premium reserve prescribed by the NAIC held for insurance benefits is deductible in

full unless something in the other provisions of Subchapter L requires the reserve to be recomputed or partially disallowed for tax purposes. I.R.C. § 807(d) may do just that. As the legislative history confirms, the computation of the federally prescribed reserve begins with the company's statutory reserve and modifies that reserve to take into account three requirements of I.R.C. § 807(d): (1) the tax reserve method applicable to the contract; (2) the prevailing state assumed interest rate or the applicable federal interest rate (AFIR), whichever is larger; and (3) the prevailing commissioners' standard tables for mortality or morbidity.²³ Other related Code sections require further adjustments, eliminating from the federally prescribed reserve any portions attributable to net deferred and uncollected premiums, excess interest guaranteed beyond the end of the table year, and deficiency reserves. Except for these prescribed adjustments and several other miscellaneous adjustments applicable to specific types of contracts, the methods and assumptions employed in computing tax reserves should be consistent with those used in computing the company's statutory reserves.

Consequently, gross premium reserves reported as statutory reserves are deductible in full except to the extent adjustments are required by specific provision of Subchapter L of the Internal Revenue Code. Sometimes a reserve provision for the risks for which statutory gross premium reserves are held must be reflected as adjustments to mortality or morbidity tables and other times to the tax reserve method itself. For example, the provision for substandard risks held in Rev. Rul. 77-451 as gross premium reserves would be reflected as an adjustment to the prevailing commissioners' standard table and the gross unearned premium reserves in *Union Mutual* would be recomputed as CRVM net premium reserves as the applicable tax reserve method. In

the case of statutory gross premium reserves for qualified supplemental benefits, no adjustment is required and the statutory reserves are deductible.²⁴

RECOMPUTATION OF VM-20 DETERMINISTIC RESERVES

In the case of the deterministic reserve component of VM-20, as with other insurance reserves, I.R.C. § 811(b) provides that the starting place is the statutory reserve, and I.R.C. § 807(d)

It is likely that the drafters did not foresee in 1984 that statutory reserves would evolve into a principle-based regime ... but they nevertheless had the foresight to defer to the NAIC in the tax reserve method so that the tax law could accommodate future reserving methodologies ...

provides for the adjustments to arrive at the federally prescribed reserve. Unlike the gross unearned premium reserves in *Union Mutual*, no adjustment is required for the tax reserve method under I.R.C. § 807(d)(3) because the deterministic reserve is an integral part of NAIC-prescribed CRVM. Therefore, the deterministic reserve is allowable as part of the tax reserve method, but other tax reserve adjustments need to be considered.

As in the case of the stochastic component of VM-20, the issues that need to be resolved are how to implement I.R.C. § 807(d)'s requirements to use the prevailing commissioners' standard tables for mortality and the interest rate assumption mandated for federally prescribed reserves. Because the deterministic reserve is based on a single scenario, a straightforward option could be to use the I.R.C. § 807(d) adjustments for the prevailing commissioners' standard table and the interest rate used for the tax-adjusted net premium reserve component of VM-20. These assumptions could be substituted for the prudent mortality assumption in Section 9.C. and the discount rates Section 7.H.4. used for the deterministic reserve component of VM-20. There are several problems with this seemingly simple approach. First, it is not clear that any adjustments for the VM-20 mortality assumptions are required under I.R.C. § 807(d)(5) in the first place. The NAIC has prescribed mortality assumptions in Section 9 of VM-20. These assumptions are required to be constructed using specified standards and can be viewed as resulting in mortality tables. These NAIC-prescribed mortality tables require sepa-

rate mortality segments for standard risks, and therefore, also could be considered "standard" tables prescribed for federally prescribed reserves by I.R.C. § 807(d)(5)(A). The reference to "standard" tables, which are prescribed for tax reserves by I.R.C. § 807(d)(5), does not refer to uniform tables applicable to all contracts; rather, it refers to tables applicable to standard risks. Contrary to an oft-expressed view of many tax practitioners, there is no requirement in I.R.C. § 807(d) that precludes a "commissioners' standard table" prescribed by the NAIC from being based on company-specific factors. In fact, since 1942 it has been established that "recognized mortality or morbidity tables" applicable to life insurance reserves under I.R.C. § 816(b) include tables authorized by the NAIC and state insurance regulators based on a single company's own experience.²⁵ Tables based on company experience are "recognized" under I.R.C. § 816(b);²⁶ there is no reason why they should not also be considered "prescribed" by the NAIC under I.R.C. § 807(d)(5). The statute does not specify how mortality tables are to be constructed, who is assigned to construct them, or what data are to be used in their development. Nor does the statute, nor even the legislative history, say that the tables must be uniform and cannot take into account individual company experience.

To the extent VM-20 also prescribes mortality assumptions for nonstandard risks, it also would seem that these assumptions could be viewed as either standard tables for the specified risk categories or as tables "adjusted as appropriate" as permitted under I.R.C. § 807(d)(1). In short, there are good arguments for the position that the prevailing commissioners' standard tables for the deterministic component of VM-20 are the same mortality assumptions prescribed by the NAIC (and 26 states) in Section 9 of VM-20.

The more difficult problem with the straightforward approach of making I.R.C. § 807(d) adjustments directly to the deterministic reserve is that substitution of the I.R.C. § 807(d)(4) interest rate assumption for the discount rate in Section 7.H.4. of VM-20 would depart from the intent of VM-20 to align the discount rates with the net asset earned rates. This disconnect between the asset-earnings rate and the discount rate would call into question whether the tax reserve method has been implemented appropriately, *i.e.*, in the manner prescribed by the NAIC, as required by I.R.C. § 807(d)(3).

For these reasons, this author prefers another approach to comply with I.R.C. § 807(d)—the Option 1 approach described for the stochastic reserves component of VM-20 in my March 2016 article. Here is how the computation of federally prescribed reserves would work. We would first make all the adjustments required by I.R.C. § 807 to the net premium reserve component of VM-20. The excess of the greater of the statutory stochastic reserve component or the deterministic reserve component over the *statutory* net premium reserve component then would

be added to the tax-adjusted net premium reserve component of VM-20. The federally prescribed reserve would be the sum of these two amounts and would thereby provide for a tax/stat reserve differential that has taken into account all of the adjustments required for federally prescribed reserves in an appropriate manner. Under this approach, we would not have to resolve the issue as to whether VM-20 mortality assumptions qualify as prevailing commissioners' standard tables or whether substitution of the I.R.C. § 807(d)(4) discount rates in the deterministic or stochastic reserve components is required.²⁷

We also would not have to resolve whether I.R.C. § 807(d)(3)(C) disallows more than just technical deficiency reserves. An appropriate tax adjustment for deficiency reserves already has been made implicitly in the net premium reserve component (because it is not increased by a net premium deficiency) and this implicit reduction in tax reserves would not be recovered by the addition of the deterministic and/or stochastic reserve components. This is another reason why I prefer the option for compliance with I.R.C. § 807(d) described above. The usual deficiency reserve adjustment would be considered to have been made to the net premium reserve component of VM-20; and, under the suggested approach, no separate deficiency-reserve-type adjustment for the deterministic or stochastic reserve component of VM-20 would be necessary.

CONTRACT-BY-CONTRACT RESERVE COMPARISON

There is a feature of both the stochastic and deterministic reserve components of VM-20 that was not discussed in my March 2016 article that merits consideration. In general, the Code contemplates a contract-specific calculation of tax reserves. This is necessary because the "amount of the life insurance reserves for any contract" under I.R.C. § 807(d) is capped by the statutory reserve and floored by the net surrender value of the contract. It has been suggested that this required contract-by-contract comparison necessarily means that statutory reserves must be computed on a seriatim basis to qualify as deductible life insurance reserves. There is little merit to this argument. As indicated earlier in this article, the determination of tax reserves begins with statutory reserves. There was nothing in pre-1984 Tax Act law that prevented a tax reserve deduction when statutory reserves were computed using aggregate assumptions and the 1984 amendments did not change that result. What the 1984 Tax Act did do, however, is require statutory reserves to be recomputed under I.R.C. § 807(d) and then be allocated appropriately to individual contracts so that the required contract-by-contract comparisons can be made.

Fortunately, the contract-level comparisons required for tax reserves are facilitated by VM-20 because it requires that a method be adopted to allocate the minimum aggregate reserves back to individual contracts. Section 2.C. of VM-20 provides that the minimum reserve for each contract is equal to the net premium reserve less the contract's portion of any credit for reinsurance

ceded plus the contract's allocated portion of any deterministic reserve excess plus the contract's allocated portion of any stochastic reserve excess. The fact that an aggregate reserve allocation methodology is provided in VM-20 is yet another reason why my preferred option for compliance with I.R.C. § 807(d) would work well. By first recomputing the net premium reserve under I.R.C. § 807(d) on a seriatim basis and then adding the *statutory* excess of the deterministic and stochastic reserves to arrive at federally prescribed reserves, it is a simple matter to allocate the statutory excess to individual contracts using the method adopted under VM-20.

AFTERTHOUGHTS

I would like to close this second article on tax law compliance for VM-20 with two observations. The first is to note that, in my opinion, the drafters of the 1984 Tax Act adopted tax reserve rules that have stood the test of time well. It is likely that the drafters did not foresee in 1984 that statutory reserves would evolve into a principle-based regime that incorporate stochastic and gross premium reserve components, but they nevertheless had the foresight to defer to the NAIC in the tax reserve method so that the tax law could accommodate future reserving methodologies and product designs requiring new reserving standards. It is true that tax professionals and actuaries may struggle with how to fit the square pegs of the I.R.C. § 807 tax reserve adjustments into the round holes of stochastic or gross premium reserves. However, the tax law compliance issues that have been wrestled with in these PBR articles can be resolved in an appropriate manner because they start with NAIC-based statutory reserves that incorporate current actuarial practice. That statutory scheme adopted by the 1984 drafters is preferable to the compliance problems that would have resulted if Congress had mandated the use of outmoded 1984-era reserve methods for tax reserves for all time.

The second observation is that, in the event comprehensive tax reform proceeds and changes are proposed to update the tax reserve provisions for life insurance companies, it is essential to retain the basic approach of the 1984 Tax Act and have statutory reserves as the foundation for tax reserves. Adjustments to statutory reserves may be necessary, just as under current law, but if Congress wants a revised tax regime for life insurance companies to remain viable for over 30 years, as the 1984 Tax Act accomplished, the tax law must be flexible enough to accommodate future changes in products, regulatory oversight and actuarial practice. Deference to the NAIC-prescribed requirements for the tax reserve method is the best way to achieve that goal. ■

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ENDNOTES

- ¹ Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *TAXING TIMES* Vol. 12, Issue 1 at 21 (March 2016).
- ² 2008-1 C.B. 363 (Jan. 14, 2008).
- ³ Treas. Reg. § 1.801-4(e).
- ⁴ 251 U.S. 342 (1920).
- ⁵ Notice 2008-18, section 4.
- ⁶ 420 F. Supp. 1181 (D. Me. 1976), *aff'd on this issue*, 570 F.2d 382 (1st Cir. 1978).
- ⁷ 574 F.2d 1067 (Ct. Cl. 1978).
- ⁸ 1977-2 C.B. 224.
- ⁹ I.R.C. § 816(b)(1)(B).
- ¹⁰ G.C.M. 37209 (Aug. 1, 1977).
- ¹¹ I.R.C. § 807(e)(3).
- ¹² *E.g.*, NAIC Health Insurance Reserves Model Regulation, Section 3.B.(2); SSAP No. 53, para. 15.
- ¹³ See, *e.g.*, Internal Revenue Service Treasury Manual, Lesson 7, "Blue Cross and Blue Shield Organizations, and Health Insurance Issues," 7-52.
- ¹⁴ *Sec. Benefit Life Ins. Co. v. United States*, 517 F. Supp. 740 (D. Kan. 1981), *aff'd*, 726 F.2d 1491 (10th Cir. 1984); *Mut. Benefit Life Ins. Co. v. Commissioner*, 488 F.2d 1101 (3d Cir. 1973); TAM 8752003 (Aug. 31, 1987).
- ¹⁵ See also Treas. Reg. § 1.801-4(e)(4).
- ¹⁶ PLR 8117033 (Jan. 27, 1981).
- ¹⁷ Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 601 (1984) (1984 Blue Book).
- ¹⁸ Pub. L. No. 99-514.
- ¹⁹ S. Rep. No. 99-313, at 975 (1986); see also H.R. Rep. No. 99-426 at 955-56 (1985).
- ²⁰ S. Prt. No. 98-169, vol. I, at 524 (1984); H.R. Rep. No. 98-432, pt. 2, at 1401 (1984).
- ²¹ If the deterministic reserve component of VM-20 were to be disallowed as a deficiency reserve under this argument, the stochastic reserve component of VM-20 presumably would increase for tax purposes.
- ²² *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).
- ²³ 1984 Blue Book at 599.
- ²⁴ I.R.C. § 807(e)(3).
- ²⁵ S. Rep. No. 77-1631 (1942), reprinted in 1942-2 C.B. 504, 612.
- ²⁶ Rev. Rul. 89-43, 1989-1 C.B. 213.
- ²⁷ In many economic scenarios this approach would yield a smaller tax reserve than if the I.R.C. § 807 adjustments were made to all VM-20 reserve components separately and then compared to each other following Section 2.A. of VM-20.



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ACLI Update

By Pete Bautz, Mandana Parsazad and Regina Rose

TAX REFORM

No one expects tax reform in 2016, but the tax writing committees in Congress have indicated they intend to brainstorm toward developing a comprehensive plan in the longer term.

REPRESENTATIVE DEVIN NUNES TAX REFORM BILL

On January 13, Rep. Nunes, R-Calif., a member of the House Ways & Means Committee (W&M), introduced the American Business Competitiveness (ABC) Act (HR4377). HR 4377 proposes a systemic change to a new basis for taxation of business income. It is referred to as a cash flow system where taxable receipts exclude investment income and business expenses are 100 percent currently deductible. To achieve this, the bill would place all taxpayers on a cash accounting basis. Section 3(b)(1) of HR4377 imposes a tax “for each taxable year on the net business income of every corporation.” Section 4(a) of the bill defines “the term ‘net business income’ . . . [as] the amount by which the taxable receipts of the business entity for the taxable year exceed the deductible amounts for the business entity for the taxable year.”

Taxation of transactions involving financial institutions is addressed in a separate section of the bill. Insurance companies are specifically included as financial institutions. Transactions between financial institutions and any entity or individual not engaged in a business activity are “covered transactions,” the proceeds of which are taxable receipts. Of particular concern is that premiums from life insurance, annuity, disability income and long-term care insurance policies sold to individuals for non-business purposes would be taxable receipts; however, deductions would be allowed only when benefits to policyholders are paid. This would mean that without a life insurance reserve deduction, a life insurer’s income would be accelerated and taxed prematurely.

ACLI and member companies have shared with Rep. Nunes’ staff the need for the proposal to provide for a life insurance reserve deduction so that life insurers’ ordinary and necessary business expenses are put on an even footing with the expenses of taxpayers in other businesses.



Kevin Brady, R-Texas, Chair of W&M Committee has encouraged members of his committee and the Republican caucus to develop and present ideas for tax reform. On March 23, the W&M Tax Policy Subcommittee held a tax reform hearing, with a particular focus on cash-flow and consumption-based approaches to taxation. Among the topics discussed during the hearing was Rep. Nunes’ ABC proposal, and the congressman appeared before the panel to promote his bill. ACLI submitted written testimony for the hearing record to emphasize the need for an insurance reserve deduction in the proposal.

ACLI staff, working with member company representatives, will continue to provide Rep. Nunes’ staff with feedback on the bill’s potential impact on life insurers.

POSSIBLE CORPORATE INTEGRATION PROPOSAL FROM SENATE FINANCE COMMITTEE

Late last year, we learned that Senate Finance Committee (SFC) staff is working, at the behest of SFC Chair Orrin Hatch, R-Utah, on a business tax reform proposal that would eliminate the double taxation on corporate income by providing a dividends paid deduction, potentially paired with a withholding tax on dividends and possibly interest paid. Under current law, corporate earnings are taxed twice, once at the corporate level and again when dividends are paid to shareholders.

Since then, ACLI has engaged member company representatives to assess how such a system would affect life insurers. ACLI staff and member company representatives have had a few meetings with SFC staff to learn more details about the proposal being developed and share industry concerns, and in particular, concerns about any proposal that might include a non-refundable withholding tax on interest and dividends.

In our most recent meeting, we explained the basics of our business model, system of regulation and investment strategy and addressed the effects of the proposal—as we understood it—on:

- The financial markets, and particularly the bond market; and
- The regulatory capital of life insurance companies.

Chairman Hatch and his staff have thanked us for our engagement and acknowledged our concerns.

PBR GUIDANCE UPDATE

Last September, ACLI submitted a letter to the IRS about its Priority Guidance Plan project concerning Life Principle-Based Reserves (PBR). The letter identified three categories of issues for guidance: (1) product qualification guidance, (2) reserve transition guidance, and (3) substantive reserve guidance. ACLI singled out product qualification guidance as the most time-sensitive set of issues due to the lead time needed to design products, secure state approvals, and design systems, and committed to follow up quickly with detailed written communication on that topic. In early November, ACLI submitted a detailed letter requesting administrative guidance by no later than the first half of 2016 on the issues relating to product guidance. ACLI and

member company representatives met with Treasury and IRS officials on March 1 to discuss the contents of the product qualification guidance request and have continued their outreach to the IRS regarding the scope of product guidance.

ACLI has begun work on a detailed letter requesting guidance on reserve transition issues as well as tax issues surrounding the statutory exemption from the requirements of Life PBR. That guidance request will be submitted during the second quarter of 2016 at which time the ACLI will begin work on the substantive reserve guidance request. ■

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T³: TAXING TIMES Tidbits

Investment Risk and the Limits of Insurance

By Patrick C. Tricker

In LTRs 201609008 (Dec. 3, 2015) and 201613016 (Dec. 28, 2015), the IRS issued final adverse determinations that two P&C insurance companies did not qualify for tax-exempt status as small insurance companies under section 501(c)(15). The companies offered a rather novel line of insurance products for businesses in addition to more traditional products. Under the products, the businesses could insure themselves against the costs of suffering a public relations crisis, having to comply with new regulations, and even losing a key customer. The IRS, however, held that these products did not qualify as insurance under the tax law, reasoning that the products protected against “investment risk” and not “insurance risk.” As a result, the companies did not qualify as insurance companies and could not obtain tax-exempt status.

The IRS’ determination letters repeated a set of factors, first articulated in CCA 201511021 (March 13, 2015), that distinguish investment risk from insurance risk and could become the basis for applying the investment risk test going forward. While prior law has defined insurance risk as requiring something more than mere investment risk, this new analysis makes the presence of investment or business risk a significant factor in disqualifying an arrangement as insurance for tax purposes. Hence, in the IRS’ view, even if a contract contains the requisite “insurance risk,” the presence of substantial investment or business risks may prevent the product from counting as insurance under the tax law.

THE NATURE OF INSURANCE

The Internal Revenue Code in fact does not define “insurance.” Instead, the courts and the IRS have acted to fill the void. In the seminal case of *Helvering v. Le Gierse*,¹ the Supreme Court decided that Congress intended the term insurance to be understood in its “commonly accepted sense.” As a result, an insurance contract must protect against “insurance risk,” which the court said consists of two essential elements: “risk-shifting” and “risk-distributing.” The court also noted that the risk involved in that case was only an “investment risk,” like the kind assumed

by a bank, rather than an “insurance risk.” While the court made this comment about investment risk primarily as a side note, this comment has given rise to a separate prong of the test for insurance contract status. A contract will not qualify as insurance even if it contains risk shifting and risk distribution if it does not also contain insurance risk, rather than mere investment risk. Later jurisprudence has summed up the definition of insurance with a three-prong test: (1) an insurance transaction must involve insurance risk, (2) it must involve risk-shifting and risk-distributing, and (3) in the absence of a statutory definition, it must be defined in its commonly accepted sense.²

The IRS emphasized the distinction between “insurance risk” and “investment risk” again in Rev. Rul. 89-96.³ In that revenue ruling, the insurance contract covered a catastrophe that had already occurred. Questions remained, however, as to how much liability would be incurred and when it would come due. The insurance company agreed to cover the loss, up to a stated amount. In denying the contract insurance status for tax purposes, the IRS observed that the amount of the premium, the investment returns on the premium, and the tax savings from qualifying as an insurance contract “would probably exceed” the maximum amount payable under the contract. The IRS noted that the transaction did not contain the necessary risk shifting because the company only took on “investment risk,” specifically the risk that it would not receive sufficient investment returns either because the liability would come due too soon or because it would receive a lower than expected investment return. Under Rev. Rul. 89-96, the risk appeared to the IRS to be insufficient where the only question was whether the invested premiums would generate sufficient returns to cover the future costs.

The test for “insurance risk” evolved in Rev. Rul. 2007-47.⁴ In this revenue ruling, an insurance company agreed to foot the cleanup costs for a high-polluting business activity once the activity ended. Like Rev. Rul. 89-96, the covered event was certain to occur but questions remained as to when the costs would have to be paid and what investment returns the company would receive in the interim. Unlike Rev. Rul. 89-96, however, a major question existed as to the extent of costs that would accrue. The contract limited the total payout, but the limit appears to exceed the projected total cost by a significant margin.⁵ Thus, the risks were not strictly investment risk in the common meaning of the term. Still, in the IRS’ view, the risks assumed by the company lacked the requisite “fortuity,” since the costs were certain to occur. The IRS found this fact sufficient to conclude that the coverage was not insurance under the tax law.

In CCA 201511021, a captive insurance company provided insurance against currency fluctuations to other members of the taxpayer group. In fashioning its position seemingly without tax precedent, the IRS “submit[ted] that all of the facts and circumstances associated with the parties in the context of the arrange-

ment should be considered.” The CCA listed a set of factors to “take into account”: (1) the ordinary activities of a business enterprise, (2) the typical activities and obligations of running a business, (3) whether an action that might be covered by a policy is in the control of the insured within a business context, (4) whether the economic risk involved is a market risk that is part of the business environment, (5) whether the insured is required by a law or regulation to pay for the covered claim, and (6) whether the action in question is willful or inevitable. Thus, instead of looking for the presence or absence of fortuity, the IRS applied a totality of the circumstances test. Based on this test, the IRS concluded that the contracts covering currency fluctuations contained investment risk and not insurance risk.

BEYOND “FORTUITY”

LTRs 201609008 and 201613016 appear to confirm that the IRS continues to apply the factor approach laid out in CCA 201511021. Importantly, these rulings show that the factor test has major substantive differences from the test that exists in court cases and official IRS guidance to date.

As noted above, in its prior rulings the IRS looked for the contracts to shift certain types of risk, specifically “fortuity” and not mere “investment risk,” to treat the contracts as insurance under the tax law. This approach, however, cannot explain the results reached in the adverse determination letters. For example, one policy in the new letters covered any tax liability above the amount on a filed tax return prepared and signed by a CPA. The IRS found the policy to have only investment or business risk, not insurance risk, even though it clearly contained fortuity. While a tax return signed by a CPA has a significant chance of showing the correct tax due, in which case the policy would pay out nothing, the tax return also has some chance to understate tax and cause the insurance to pay out proceeds. Another policy provided insurance against the loss of a major customer, although the policy would not cover the loss if the insured initiated the termination or did not attempt to replace the customer. Here again, a significant fortuity exists that the business would lose the customer and incur a financial loss for reasons beyond its control. These policies would seem to pass the test outlined in Rev. Ruls. 89-96 and 2007-47.

Perhaps even more significantly, following the IRS’ reasoning, the presence of certain types of investment or business risk coverage appears able to disqualify a contract as insurance for tax purposes, even where it otherwise contains the requisite insurance risk. One of the products in the letters covered the involuntary loss of a key employee if the loss resulted from the sickness, disability, death, loss of license, or retirement of the employee. The contract did not provide coverage if the insured fired the employee. Here again, the policy contains fortuity. The key employee could continue working for the insured, but may not do so if one of the covered conditions occurs. The IRS noted that

a policy covering the death or disability of the employee would qualify as insurance. However, the contract involved also covered investment or business risks, such as the loss of license or retirement of the employee. As a result of covering these other risks, the IRS held that the contract did not qualify as insurance under the tax law. Based on the letters’ reasoning, it appears that a contract covering both business risk and insurance risk does not qualify as an insurance contract. This result cannot be squared with the insurance risk test that currently exists in precedential guidance.

Treating investment risk as a disqualifying factor would fundamentally shift the nature of the insurance risk test to one that is comparative in nature. Instead of asking whether sufficient insurance risk exists in the product, the IRS’ approach asks whether the risk present more closely resembles an insurance risk or an investment risk. The Tax Court recently rejected such an approach in *R.V.I. Guaranty Co. v. Comm*’⁶ in deciding that residual value insurance had the requisite insurance risk to qualify as insurance for tax purposes. The IRS argued, among other things, that the products contained only investment risk because they resembled a put option on stocks. Like put options, the product paid out proceeds to compensate for an asset’s loss in value below a certain level. The Tax Court rejected this argument and stated that “courts have long held that a product can be ‘insurance’ even though competing products exist in the financial market place.”⁷ As such, an insurance product can look like a financial product, even act in the same manner as common financial products, without losing its characterization as insurance for tax purposes. Also worth noting, the Tax Court appears to be moving away from the fortuity approach. The decision notes the existence of a fortuitous event but appears to base its conclusions on a broad analysis of state law and expert testimony. This kind of analysis tends to imply a “facts and circumstances” approach and resists a bright-line rule that previous guidance has tried to create.

Examining the products in the letters, it is noteworthy that many of these products have little to do with “investment risk” in the common usage of the term. By its nature, investment risk refers to the uncertainty of the returns from investing money and the chance that the investment will lose some or all of its value. Many of these products, however, involve no real investment risk, beyond the time between when the premiums are paid and when the insurance becomes payable. For example, one of the products offered coverage in the event of a public relations crisis. The policy included a defined series of incidents that would constitute a public relations crisis. But does a public relations crisis constitute an investment risk? This seems unlikely. A public relations crisis would presumably hurt a shareholder’s investments in a company, but it does not directly affect the company’s investments. To frame the issue another way, if a high profile individual—such as a celebrity or politician—purchased public relations insurance, the risk would be entirely detached from any

investment. Reputation, rather than investment or even profit, would be on the line.

Unlike the currency fluctuation coverage in CCA 201511021, the products in the determination letters really cover business risk, not investment risk. A PR crisis, the loss of a key customer, and the loss of a key employee are business risks rather than investment risks. In the determination letters, the IRS appears to be drawing a line between the events covered by insurance and the risk that a business undertakes on a day-to-day basis. The IRS, it seems, has framed the issue as the contracts' assumption of "investment or business risk" because no precedent exists for disqualifying an insurance contract as such merely because it covers a business risk. To make sense of these results, however, it is necessary to view "business risk" as something different than the "investment risk" prong as it currently exists, perhaps even as a new prong of the insurance risk test.

Indeed, the "investment risk" prong of the Supreme Court's test in *Helvering v. Le Gierse* would need a fundamental change to act as it does in the determination letters. Far from a disqualifying fact, the Supreme Court has held that investment risk can be an important aspect of an insurance product.⁸ Treating investment risk as disqualifying an insurance product would turn this result on its head. Thus, the investment risk test is being applied in the determination letters in a fundamentally different and even contradictory manner than it has in the past.

In sum, a significant problem is posed by the approach the IRS has taken in the determination letters. Using a totality of the circumstances test like this one has the effect of defining insurance as it currently exists, because new features or coverage would make a product look less like insurance as traditionally conceived of. Adhering to such an approach risks constraining future innovation within the insurance industry. Such a route should never be taken lightly. In the words of Supreme Court Justice William O. Douglas, "[I]nsurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of 'insurance' or 'annuity' into the mold they fitted when these Federal Acts [the securities laws] were passed."⁹

A COMMENT ON CONTEXT

Up until now, this article has sidestepped the context that gave rise to this issue. In theory, the context should have no bearing on the IRS' analysis and would only distract from understanding the IRS' application of the insurance risk test. In practice however, the situation here may involve transactions that the IRS views as abusive of the tax law, and this abuse may have influenced the IRS' conclusions.

The primary issue in the determination letters was whether the companies issuing the products qualified as small insurance com-

panies tax exempt under section 501(c)(15). Based on the above analysis, the IRS concluded that the products sold by the companies were not insurance products and therefore the companies did not qualify as insurance companies under section 816(c), leading to denying their applications for tax-exempt status.

The companies, however, only sold the insurance products to affiliated corporations, specifically those companies held by the same group of owners. The owners appeared to have set up the company and issued the insurance contracts to take advantage of the tax exempt status allowed for small insurance companies.

The IRS may not take such a strict position as it has in the determination letters in more traditional situations where an insurance company seeks to offer new products to the general public. Additionally, of course, the determination letters discussed here are not precedential, and so they do not bind other taxpayers, nor do they bind the IRS in future matters. Even so, the decisions announced and the rationales offered in these determination letters appear to signal a new stage in the IRS' development of the insurance risk test. ■

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ENDNOTES

- ¹ 312 U.S. 531 (1941).
- ² See, e.g., *AMERCO, Inc. v. Comm'r*, 979 F.2d 162, 165 (1992).
- ³ 1989-2 C.B. 114.
- ⁴ 2007-2 C.B. 127.
- ⁵ The revenue ruling omits the likelihood that the total costs of cleanup would exceed the contractual limit. This is interesting because the pivotal fact in Rev. Rul. 89-96 was that the costs were likely to exceed the contract limits, giving the contract a defined payout and making it look more like an investment contract than an insurance contract. Here however, the contract appears to have been fairly priced, with a premium set at the present value of the expected future costs. The limit on the contract was set at twice the premium paid.
- ⁶ 145 T.C. No. 9 (Sept. 21, 2015).
- ⁷ See *id.* at 23 (Slip opinion).
- ⁸ See *Sec. and Exch. Comm'n v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *Sec. and Exch. Comm'n v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).
- ⁹ See *Sec. and Exch. Comm'n v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 70 (1959).

The Second Circuit Reaffirms the work-product Doctrine's Scope

By Kenan Mullis

When tax controversy or litigation is anticipated, retaining confidentiality of documents is of the utmost importance. Fortunately, a recent decision brings good news for taxpayers. In *Schaeffler v. United States*,¹ the United States Court of Appeals for the Second Circuit issued a taxpayer-friendly decision on the scope of the attorney-client privilege and the work-product doctrine, holding that (1) the taxpayer did not waive attorney-client privilege² when it shared a document created by an accounting firm with a consortium of banks because the taxpayer and banks shared a common legal interest; and (2) the work-product doctrine also protected the documents. Significantly, the court's work-product doctrine holding departs from the analysis used by the First Circuit Court of Appeals in *United States v. Textron*³ to hold that the work-product doctrine did not protect tax accrual workpapers. Further, the *Schaeffler* decision should prove useful for taxpayers pursuing issues on a mutual basis with other parties who have a common interest.

Georg Schaeffler was the 80 percent owner of the Schaeffler Group (collectively, "Schaeffler"), an automotive and industrial parts supplier incorporated in Germany. In 2008, Schaeffler sought to acquire a minority interest in the German company Continental AG by means of a tender offer financed with an €11 billion loan from a consortium of banks. German law prohibits a tender offer seeking less than all of a company's shares, so Schaeffler made the offer at a price that was estimated to result in the acquisition of the desired number of shares. During the offer period, the financial crisis of 2008 significantly worsened, the price of Continental AG shares fell sharply, and because German law prohibited the offer's withdrawal, far more shareholders than anticipated accepted the offer. Schaeffler emerged as the 90 percent owner of Continental AG, a result that threatened Schaeffler's solvency and ability to repay the bank consortium's loan.

Schaeffler and the consortium sought to refinance the debt and restructure the group. Due to the complexity of the refinancing and restructuring, and anticipating IRS scrutiny of the U.S. tax consequences, Schaeffler retained Ernst & Young (EY)

and Dentons US LLP, and it executed an agreement with the consortium to share legal analyses. When the IRS did, indeed, commence an audit, Schaeffler sought to quash the IRS's demand for tax opinions, arguing both that they were privileged and entitled to protection as attorney work-product. A district court denied the petition to quash, holding that Schaeffler had waived attorney-client privilege by sharing the documents with the bank consortium and also rejecting the work-product claim. On appeal, the Second Circuit vacated and remanded the district court's decision.

Attorney-client privilege protects communications between a lawyer and his or her client that are intended to be (and in fact are) kept confidential for the purpose of obtaining or providing legal advice. It is intended to encourage clients to communicate freely and openly with their lawyer. Generally, the privilege is deemed waived if the client voluntarily discloses otherwise-privileged information to a third party. However, privilege is not destroyed where the client has a common legal interest with that third party, and the communication is in furtherance of that ongoing common enterprise.⁴

Against this background, the Second Circuit examined whether the bank consortium's common interest with Schaeffler was "of a sufficient legal character" to avoid waiver of the privilege upon the sharing of documents prepared by EY with the banks. In holding that it was, the court noted several facts. According to the court, both parties stood to avoid a "mutual financial disaster" (that is, Schaeffler's insolvency and resulting default on the consortium's loan) by securing a particular tax treatment for the refinancing and restructuring. Securing this treatment, they expected, would involve a legal encounter with the IRS, and thus, both Schaeffler and the banks had a common interest in that legal encounter's outcome. The court further explained that the EY documents at issue were "directed to the tax issues, a legal problem albeit with commercial consequences," and that "[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests."⁵

As *Schaeffler* shows, before sharing otherwise-privileged documents, taxpayers and tax professionals should take care to distinguish between a shared interest that is purely commercial and a shared interest in a legal outcome that affects a commercial interest. Further, attorney-client privilege requires that the purpose of a communication be to obtain or provide legal advice, and therefore a document shared under the theory of a common legal interest also must be for the acquisition or provision of legal advice. A document drafted to assess the commercial wisdom or commercial consequences of various decisions, even if legal advice is contained therein, will not be protected. Thus, the author of a document that will be shared should clearly identify the parties' common legal interest or common legal strategy to obtain a particular legal outcome. Once

shared, to protect against waiver of the privilege, each party should assure that the shared document is not disseminated.

The IRS has always, to a certain extent, coordinated its efforts to pursue issues that cut across the insurance industry. It is likely this coordination will only increase as a result of the Large Business & International Division's recent restructuring, which will move examinations toward an issue-based, or "campaign," approach.⁶ This could give rise to an even greater need for companies to coordinate their efforts on common issues, and the *Schaeffler* decision will be an important and beneficial tool as these efforts go forward.

The second important holding in *Schaeffler* involved the work-product doctrine. That doctrine protects certain documents prepared in anticipation of litigation from discovery, and it is intended to permit lawyers to prepare and develop strategies without unnecessary intrusion by adversaries.⁷ Though it most frequently involves an attorney's work, protection also may extend to items prepared by non-attorneys.⁸ A document prepared in anticipation of litigation remains work-product even where it is a "dual-purpose document" that will also assist in business dealings.⁹

In holding that the work-product doctrine did apply to the EY documents, the Second Circuit reaffirmed that its governing precedent (*United States v. Adlman*) required the application of a "because of" test; that is, whether a document was prepared or obtained *because of* the prospect of litigation. As the court explained, the tax advice in the EY documents was geared to an anticipated audit and the litigation that likely would follow. Indeed, considering the transaction's size and the complexity and ambiguity of the tax issues, the court stated that any hypothetical scenario where parties to this transaction did not have an eye towards litigation (as the district court had imagined in its analysis) would be "at odds with reality."¹⁰

The Second Circuit's work-product analysis, which relies heavily on *Adlman* and its "because of" standard, should provide some comfort to taxpayers and tax professionals after the First Circuit's 2009 decision in *United States v. Textron* that tax accrual workpapers were not protected because they were not "prepared for use in" potential litigation. The *Schaeffler* decision confirms that the "because of" standard remains the prevailing test for work-product protection in the Second Circuit and most of the rest of the country,¹¹ and *Textron's* more restrictive "prepared for use in" standard governs only in the First Circuit. Thus, in most circuits, a memorandum drafted by a tax professional for a client should be protected if it is prepared because of anticipated litigation, even if it will assist in business dealings. Nevertheless, some practical steps could help to enhance the chances of such a memorandum receiving work-product protection: the author might include in the document language that potential litigation with the IRS is anticipated, and the document is being prepared to assist in that potential litigation; and, to avoid waiver, the author should not share the document beyond those who need to see it.

It is common for actuaries to be called upon to support tax departments when tax issues arise. In addition to the informative look at the bounds of the work-product doctrine, *Schaeffler* provides an opportunity to underscore the importance of remembering those practical measures that can lessen the risk that a document prepared in such a support role will be inadvertently discoverable.

The *Schaeffler* decision should ease worry that *Textron* represented a shift toward a narrower application of the work-product doctrine. Instead, it appears that *Textron's* analysis will be limited to the First Circuit (which covers Maine, New Hampshire, Massachusetts, Rhode Island, and Puerto Rico). Still, tax professionals and actuaries should navigate carefully when preparing documents they expect will be protected from discovery under the work-product doctrine. ■

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ENDNOTES

¹ 806 F.3d 34 (2d Cir. Nov. 10, 2015), *vacating and remanding* 22 F. Supp.3d 319 (S.D.N.Y. May 28, 2014).

² Section 7525(a) of the Internal Revenue Code provides that the common law protections of confidentiality applicable to communications between a taxpayer and an attorney also apply to communications between a taxpayer and a federally authorized tax practitioner with respect to tax advice. This generally is known as the "tax practitioner privilege," and it may only be asserted in noncriminal tax matters before the IRS and in noncriminal proceedings in federal court brought by or against the United States. It is essentially coterminous with the attorney-client privilege in terms of scope and waiver in those proceedings. See *United States v. BDO Seidman*, 337 F.3d 802, 810 (7th Cir. 2003); *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793, 798 (2012). For simplicity, this article will refer to both as attorney-client privilege.

³ 577 F.3d 21 (1st Cir. Aug. 13, 2009).

⁴ *Schaeffler*, 806 F.3d at 40 (citing *United States v. Schwimmer*, 892 F.2d 237 (2d Cir. 1989)).

⁵ *Id.* at 41-42.

⁶ See IRS Publication 5125, *Large Business & International Examination Process* (Feb. 2016).

⁷ Fed. R. Civ. P. 26(b)(3); *Hickman v. Taylor*, 329 U.S. 495 (1947); *Schaeffler* at 43 (citing *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998)).

⁸ Rule 26(b)(3) of the Federal Rules of Civil Procedure states the general rule that "a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent)."

⁹ *Schaeffler*, 806 F.3d at 43 (citing *Adlman*).

¹⁰ *Id.* at 44.

¹¹ See, e.g., *In re Grand Jury Proceedings*, 604 F.2d 798 (3d Cir. 1979); *Nat'l Union Fire Ins. Co. of Pittsburgh v. Murray Sheet Metal Co.*, 967 F.2d 980 (4th Cir. 1992); *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109 (7th Cir. 1983); *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (8th Cir. 1987); *In re Grand Jury Subpoena (Torf)*, 357 F.3d 900 (9th Cir. 2003). *But see United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) (using a "primary motivating purpose" test).

Subchapter L: Can You Believe it?

Reserves for Annuity Contracts That Flunk I.R.C. § 72(s) Can Be Deductible

By Peter H. Winslow

In two of my *TAXING TIMES* columns last year, I dealt with the policyholder and company tax treatment of contracts that fail to qualify as life insurance contracts under I.R.C. § 7702.¹ In the October 2015 *TAXING TIMES* column, I pointed out that a life insurance company is entitled to a tax reserve deduction for a contract that flunks I.R.C. § 7702. After writing that piece, I have been asked: What about the tax treatment of contracts that do not qualify as annuity contracts for tax purposes because they lack the requisite distribution-after-death provisions of I.R.C. § 72(s)? As it turns out, the same result applies as for failed life insurance contracts—the life insurance company should obtain a tax reserve deduction for a contract that fails to qualify as an annuity contract under I.R.C. § 72(s) provided the contract has a lifetime annuity payout option.

Let's explore how this is the likely result. I.R.C. § 72(s) provides, with certain exceptions, that a contract is not treated as an annuity contract “for purposes of this title” unless it provides that annuity benefits will be distributed within five years of the holder's death or, if annuitization had commenced before death, at least as rapidly as under the method of distribu-

tion being used at the time of death. The phrase “for purposes of this title” refers to all provisions of the Internal Revenue Code, that is, Title 26 of the United States Code. This means that when determining the issuing company's tax treatment of a contract that flunks I.R.C. § 72(s) the contract cannot be considered an annuity contract. This broad application of I.R.C. § 72(s) has significant potential ramifications.

The company tax issues that need to be addressed when a contract fails to qualify as an annuity contract under I.R.C. § 72(s) are: (1) whether the premium is includible in income; (2) if so, the type of insurance reserve deduction that is applicable; and (3) whether the policy acquisition expenses (DAC) provisions apply. The DAC issue is the easiest to answer. Under I.R.C. § 848(c)(1), only specified insurance contracts are subject to the so-called “DAC tax” whereby expenses equal to a designated percentage of net premiums (1.75 percent in the case of annuity contracts) are required to be capitalized and amortized as a deduction ratably over a 120-month period. Specified insurance contracts are limited to life insurance, annuity and noncancelable (or guaranteed renewable) accident and health insurance contracts. Because a failed annuity is not an annuity contract for tax purposes by reason of I.R.C. § 72(s), it is not a specified insurance contract and the DAC tax does not apply. As a result, the recurring expenses incurred to sell the contracts are currently deductible. Regulations under I.R.C. § 162 provide that “advertising and other selling expenses” are currently deductible on an accrual basis as ordinary and necessary business expenses.²

Whether the premium for a failed annuity is includible in the issuer's gross income requires more analysis. The answer lies in determining whether the contract qualifies as an insurance contract. If it does, the consideration received from the contract holder would be includible when accrued as premium income.³ Guidance in IRS rulings primarily relating to pre-1984 Act law and in analogous 1984 Act legislative history suggests that, to de-



termine whether a contract that provides for periodic payments is insurance, we first should examine whether a payout option is available that incorporates life contingencies, *i.e.*, a payment option for life is available. Next, for a failed deferred annuity we examine whether, during the deferral stage of the contract, purchase rates for the life-contingent payout options are guaranteed. If the contract provides only a term certain annuity option, or if there are no meaningful purchase rate guarantees, the contract likely is considered debt for tax purposes. In such case, the same tax treatment as a guaranteed investment contract would apply—no premium income and no reserve deduction. On the other hand, if a life annuity payment option is available for a failed deferred annuity and there are meaningful purchase rate guarantees, the contract likely would qualify as an insurance contract for tax purposes, albeit not an annuity or life insurance contract. As a result, premium income with a corresponding insurance reserve deduction would be the correct treatment for the company issuing the contract. This insurance contract characterization is supported by legislative history that concludes that a failed life contract and a deposit administration contract that is not an annuity because it lacks permanent purchase rate guarantees are nevertheless insurance contracts for which reserve deductions are available.⁴

As in the case of a failed life insurance contract, a contract's failure to satisfy the criteria for annuity contract treatment under I.R.C. § 72(s) means that the tax reserve computational rules in I.R.C. § 807(d) do not apply. By its terms, I.R.C. § 807(d) only applies to life insurance reserves which, like the DAC rules, are held only with respect to life insurance, annuity and noncancelable (or guaranteed renewable) accident and health insurance contracts.⁵ Because I.R.C. § 72(s) provides that a contract cannot be an annuity contract for all purposes of the Internal Revenue Code if it fails to include the requisite distribution-after-death provisions, reserves held for the contract cannot be subject to the I.R.C. § 807(d) tax reserve computational rules. Again, analogous legislative history under the 1984 Act is helpful in determining the proper classification of the reserve. In the case of a deposit administration contract that is a failed annuity because it lacks permanent purchase rate guarantees, the legislative history says that a reserve deduction is available under I.R.C. § 807(c)(3) or (4).⁶ In general, for a failed deferred annuity, the applicable classification would be an I.R.C. § 807(c)(4) reserve—"amounts held at interest in connection with insurance ... contracts," assuming the deferred annuity has an identifiable account value to which interest is added. The amount of the tax reserves for this type of contract would be the full account value of the contract to which interest is added.

What happens if the contract annuitizes? The most likely tax treatment upon annuitization is that the tax character of the contract changes. After annuitization, in most cases where a life time annuity payout option is elected the contract would sat-

isfy the distribution-after-death requirements of I.R.C. § 72(s) going forward. The fact that the contract previously did not qualify does not seem to matter. Unlike I.R.C. § 7702 for a life insurance contract, I.R.C. § 72(s) qualification does not require compliance "at any time," *i.e.*, including all prior contract years. Therefore, there is no reason why a previously failed contract would not qualify as an annuity once I.R.C. § 72(s) criteria are satisfied. If that is the case, then the tax treatment at annuitization probably would be similar to a deposit administration contract with temporary purchase rate guarantees upon annuitization. The insurance contract (*i.e.*, the failed annuity) would be considered surrendered. The I.R.C. § 807(c)(4) reserve would be released generating income that would be offset by a deduction for the deemed payment of the account value upon the surrender. The account value would then be applied as the purchase price of the now-I.R.C. § 72(s)-compliant annuity contract and included in premium income. The premium income would be subject to the DAC tax and a new reserve—now a life insurance reserve—would be computed subject to the tax reserve adjustments required by I.R.C. § 807(d).

It is unlikely that Congress gave much thought to the issuer's tax consequences for failed annuity contracts in enacting the 1984 Act. But, whether or not Congress intended the results outlined in this column, following the requirements of the Internal Revenue Code where they lead for failed annuity contracts does not seem to give an adverse answer for the issuing company, at least when the contract retains its character as insurance. ■

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ENDNOTES

- ¹ Peter H. Winslow, "Subchapter L: Can You Believe It? Withholding and Reporting May Not be Required for Income on Failed Life Insurance Contracts," *TAXING TIMES* Vol. 11, issue 2, page 52 (June 2015); Peter H. Winslow, "Subchapter L: Can You Believe It? Deductible Tax Reserves Might be Greater for Life Insurance Contracts That Flunk I.R.C. § 7702 Than for Those That Do Not," *TAXING TIMES* Vol. 11, issue 3, page 46 (October 2015).
- ² Treas. Reg. § 1.162-1(a).
- ³ I.R.C. § 803(a)(1).
- ⁴ H.R. Rep. No. 98-432, pt. 2, at 1413 n.128 (1984); Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 597 n.19 (1984).
- ⁵ I.R.C. § 807(c)(1), § 816(b).
- ⁶ H.R. Rep. No. 98-432, pt. 2, at 1403 n.125 (1984); Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 584 n.8 (1984).



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