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# ACLI UPDATE DEFICIENCY RESERVE GUIDANCE

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**O**n Tuesday, Feb. 26, 2013, the Internal Revenue Service (IRS) released Notice 2013-19, which provides guidance on whether deficiency reserves are included in “statutory reserves” as defined in section 807(d)(6) of the Internal Revenue Code for purposes of applying the limitation set forth in the statutory reserve cap (the “statutory cap”) in section 807(d)(1) of the Code.

The Notice does not include a statement of facts or a conclusion. However, the Notice relies on an extensive review of the legislative histories of sections 807 and 816(h) and former section 809(b)(2) to provide, in a “Scope and Application” section, that for purposes of applying the limitation set forth in the statutory cap, deficiency reserves are included in the amount taken into account with respect to a life insurance contract in determining statutory reserves under section 807(d)(6).

This statement in the Scope and Application section is consistent with the guidance the American Council of Life Insurers (ACLI) requested in its May 1, 2012 letter to the IRS—as well as in several prior year ACLI letters—in which it sought inclusion of this matter on the IRS Priority Guidance Plan. In fact, this item has appeared on the IRS Priority Guidance Plans for the past several years.

## GUIDANCE ON PRINCIPLE-BASED RESERVES AND AG 43 STATUTORY CAP

The ACLI submitted a letter in May 2012 requesting inclusion on the 2012–2013 IRS Priority Guidance Plan of, among other things, guidance (i) on tax issues arising under section 807 of the Code as a result of the adoption by the National Association of Insurance Commissioners (NAIC) of a principle-based approach to certain life insurance reserves, (ii) clarifying that for taxable years ending on or after Dec. 31, 2009, the aggregate Conditional Tail Expectation amount in excess of the Standard Scenario Amount for annuity contracts falling within the scope of Actuarial Guideline 43 should be taken into account in computing the amount of statutory reserves under § 807(d)(6).

While the AG 43 statutory cap issue appears on the 2012–2013 IRS Priority Guidance Plan, guidance on principle-based reserves (PBR) does not. Nevertheless, the ACLI and its members continue to work actively with the IRS on the possible provision of guidance on both of these important topics.

## CAMP DISCUSSION DRAFT ON FINANCIAL PRODUCTS

On Jan. 24, 2013, House Ways and Means Committee Chairman Dave Camp, R-Mich., released a financial products discussion draft (the “Discussion Draft”) as part of the committee’s broader efforts on comprehensive tax reform. Under the Discussion Draft, most financial derivatives would be taxed under the mark-to-market accounting rules and would produce ordinary income. The Discussion Draft also would repeal rules under Section 1256 of the Code that allow securities dealers to pay taxes at long-term capital gains rates on 60 percent of their derivatives income and ordinary income tax rates on the remaining 40 percent. The Discussion Draft also would change the tax code to simplify business hedging rules, eliminate “phantom” taxes that result from debt restructurings, modify the taxation of market discount on bonds, limit the options for computing tax basis, and establish tighter rules to prevent wash-sales from occurring.

The ACLI’s Investment Tax Subgroup—composed of investment tax professionals from our member companies—has been analyzing the Discussion Draft to determine how the proposals would impact life insurance companies and their products. The ACLI expects to use the Investment Tax Subgroup’s analysis to determine the scope and nature of any possible ACLI outreach to the Ways and Means Committee regarding the Discussion Draft.

## FOREIGN ACCOUNT TAX COMPLIANCE ACT

On Jan. 17, 2013, IRS and Treasury released “Final Regulations Relating to Information Reporting by Foreign Financial Institutions (“FFIs”) and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities,” more commonly known as the Foreign Account

Tax Compliance Act (“FATCA”) Final Regulations. These Regulations will take effect beginning Jan. 1, 2014. In particular, all pre-existing life insurance contracts with a balance of \$250,000 or less prior to the compliance date are exempted from withholding.

For new cash value life insurance contracts, contracts with a value of \$50,000 or less are excepted from the definition of a financial account and are therefore not subject to FATCA. The Final Regulations do not provide similar treatment for annuity contracts with a cash value.

The Final Regulations were responsive to ACLI’s requests for guidance and were in large part an improvement on the rules for life insurance products and companies contained in the Proposed Regulations issued February 2012. The Final Regulations also provided that:

- Term life insurance contracts were specifically excluded from financial account status. The definition in the Proposed Regulations was expanded to include term life insurance contracts with increasing premiums. However, term life insurance contracts with a return of premium feature that refunds any more than the premiums paid, less mortality, morbidity and expense charges, are not excluded from financial account status under FATCA.
- Indemnity reinsurance contracts are specifically excluded from FATCA.
- The death benefit under a cash value insurance contract is effectively treated as a financial account, and the beneficiaries of cash value life insurance contracts are presumed to be non-U.S. persons unless the FFI has actual knowledge or reason to know that the beneficiary is a U.S. person.
- Grandfathered obligations include life insurance contracts payable no later than upon the death of the insured individual(s). This expansion from the definition in the Proposed Regulations provides meaningful relief from withholding on all preexisting cash value life insurance contracts regardless of the amount of cash value. The Final Regulations also treat premiums paid for an insurance contract or annuity contract that is treated as a grandfathered obligation, as payments made under a grandfathered obligation. Such payments are therefore also grandfathered and exempt from FATCA withholding.

- References in the Proposed Regulations to U.S. tax law rules when defining “annuity contract,” “life insurance contract,” and “insurance company” were modified to eliminate the need for foreign companies to become proficient in the specialized definitions of these terms under U.S. tax rules. Final Regulations replace the references to U.S. tax law rules with plain language definitions and incorporate, where appropriate, references to local law definitions and practices.

- For retirement and pension accounts, the excepted category is revised to eliminate the requirements that all contributions to the account be government, employer or employee contributions and be limited to earned income. In addition, the limitation on contributions is liberalized to allow plans to have an annual contribution limit of \$50,000 or less or to have a maximum lifetime contribution limit of \$1,000,000 or less. The Final Regulations also add the condition that the relevant tax authorities require information reporting with respect to the account.

- For non-retirement savings accounts, the Final Regulations eliminate the requirement that contributions be limited by a reference to earned income, but the Regulations require that the account be tax favored in the jurisdiction where the account is maintained and annual contributions are limited to \$50,000 or less.

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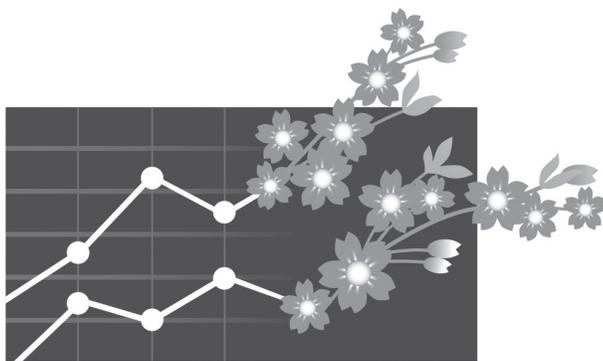
Although these regulations are final, ACLI and its members are studying the rules to provide feedback to and seek clarification from Treasury and IRS on any areas where the rules are highly ambiguous or absolutely unworkable.

### CHANGES ON NON-FORFEITURE LAWS TO LOWER INTEREST RATES

In the current low interest rate environment, it has been pointed out that there is a potential for the statutory interest rates governing minimum non-forfeiture values to go low enough to create a conflict with the 4 percent rate required by section 7702's Cash Value Accumulation Test.

The ACLI tax working groups and Actuarial Committee have met to consider developing a position on how the industry should address the potential for non-forfeiture rates below

4 percent. Although the probability of a rate change in 2013 is very low, it was the groups' consensus that ACLI begin to address the issue. Since the NAIC model is being currently considered by some states as part of the Principles-Based Reserves legislative package, there is an existing vehicle for such a change. Members are drafting language to incorporate in the standard non-forfeiture law that will prevent a conflict between the statutory interest rates governing minimum non-forfeiture values and the rate required by section 7702's Cash Value Accumulation Test. ◀



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