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PROPOSED GUIDANCE ON THE NEW NET INVESTMENT INCOME TAX ON "ANNUITIES"

By John T. Adney and Alison R. Peak

As part of the health care legislation enacted in March of 2010, Congress added new section 1411 to the Internal Revenue Code,[1] imposing a 3.8 percent tax on certain types of "net investment income" of high income taxpayers beginning this year (referred to herein as the "Investment Income Tax" or the "new tax"). As described more fully below, the Investment Income Tax applies to, among other things, gross income from "annuities" as well as from certain dispositions of property. On Nov. 30, 2012, the Department of the Treasury and the Internal Revenue Service ("IRS") published proposed regulations explaining the application and scope of the new tax.[2] In this article, we briefly review the background and history of the new tax and then describe and examine in detail the proposed regulations and how they affect taxpayers holding annuity and life insurance contracts.

BACKGROUND & HISTORY

The Health Care and Education Reconciliation Act of 2010 added section 1411 to the Code effective for taxable years beginning after Dec. 31, 2012.[3] For additional background on this new provision and the manner in which it was enacted, we refer you to our September 2010 *Taxing Times* article, "Tapping a New Revenue Source—Congress Expands the Medicare Tax Base to Include Income from 'Annuities.'"

As noted above, the new provision imposes a 3.8 percent tax on certain types of "net investment income" of taxpayers with higher incomes—technically, those who have "adjusted gross income" exceeding thresholds specified in the provision. More specifically, the tax applies to the lesser of (A) an individual's "net investment income" for a year, or (B) the individual's (i) "modified adjusted gross income" ("MAGI") for the year, over (ii) the "threshold

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FROM THE EDITOR

TO OUR READERS

By Christian DesRochers

"You've got to ask yourself a question: do I feel lucky?"
—Clint Eastwood, *Dirty Harry*, 1971

What does luck have to do with *Taxing Times*? Luck impacts a number of things, including the tasks of putting the issues together and publishing them on time. However, in this column, I'd like to talk about risk and tax risk in particular. Several months ago, I attended a meeting of insurance professionals, in which the issue of the various risks that insurance companies face was discussed. As I listened to the presentation (complete with the mandatory PowerPoints), I was struck by the lack of discussion of tax among the various risks that an insurance company faces. As tax professionals, perhaps we have not done enough to educate management and others as to the various tax-related issues that insurance companies face. Alternatively, we may be doing such a good job managing those risks that others don't need to worry, since we have it all under control. However, the skeptic would say that the truth lies in the former, and not the latter, observation.

We can classify tax risk into two broad categories: The first deals with products, while the second relates to the taxation of life insurance companies. With respect to products, the interest earned on life insurance and annuity products is not taxable to the policyholder until it is distributed, and life insurance death benefits are not taxable to the beneficiary, for both individual and corporate policyholders. This treatment had been applied to life insurance and annuity products since the inception of the income tax. However, since the treatment of "inside buildup" is considered a tax expenditure by the Treasury and Joint Committee on Taxation, it is receiving increasing scrutiny in the current economic environment, as both states and the federal government continue to look for increased sources of tax revenue. Thus, one key product risk is that the current tax treatment of life insurance and annuity products could be changed legislatively. That risk is well recognized by industry leaders, and obviously the industry would strongly resist any legislative change.

Another risk to products is where the tax law changes and the treatment of a life insurance product or the demand for that product is modified. The changes to the deductibility of policy loan interest, first to individuals, and later to corporations, were an example of a changing tax environment that affected the way in which life insurance products were sold. A similar example is the estate tax. If the estate tax were to be permanently eliminated, the demand for products would also change.

Since 1984, the tax treatment of life insurance has come with an administrative cost, in the form of the definition of life insurance under section 7702 and the modified endowment contract (MEC) rules under section 7702A. I can speak with some firsthand knowledge that at the time no one really considered the long-term implications of record keeping and data integrity when these provisions were being put in place. Since administration of the rules falls across multiple disciplines—tax professionals, actuaries and policy administrators—it is often the case that errors are made in the design and administration of products, particularly where products are moving from one administrative system to another. In some cases, errors may go undiscovered for a significant period of time. While there are procedures in place within the Internal Revenue Service to deal with "failed contracts" and "inadvertent MECs," the process can be very resource intensive and costly. A closely related product tax risk is that the actual failure or concern with potential failure to properly administer contracts can lead to increased due diligence expenses and significant remediation costs relative to a sale or acquisition of business or a company.

From the corporate side, there are a number of issues to consider as well. As is the case for policyholder issues, there is also legislative risk on the corporate side. We see that in the on-going efforts in the administration's budget proposals to alter the tax treatment of dividends received at both the general and separate accounts through changes in the dividends-received deduction. Whether changes will be made to the taxation of life companies as part of broad corporate tax reform is also an issue. The effects of the development of principle-based reserves are also unclear, not only with respect to the deductibility of non-formulaic reserves, but also with the continuing issue of changing reserve standards in the face of a statute that looks to issue-year reserves. During the financial crisis, we saw the mismatch of hedge income with asset adequacy reserves, which are generally not deductible, creating issues that are still being resolved today.

Corporate tax is also a significant element in the analysis of acquisitions and reinsurance. If the projected (or hoped for) tax treatment of a transaction does not ultimately emerge, then the risk to profitability is just as real as one that arises from a misestimate in projections of future actuarial assumptions, or from any other tax-related issue.

What does any of this have to do with risk? Unless one follows Clint Eastwood, or perhaps Napoleon who sought out lucky generals, tax risk in its various forms is very real, and it can have a significant economic impact on an insurance company. The challenge for tax professionals is to raise awareness among the various constituencies that, along with other risks an insurance company faces, tax risk is one that should be actively monitored and managed. Raising the visibility of tax among the insurance risk community would seem to be a viable and prudent first step. ◀

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FROM THE CHAIR
WHERE WOULD WE BE WITHOUT VOLUNTEERS?

By Mary Elizabeth Caramagno

The Taxation Section has a long history of providing high-quality, timely educational materials for its members. From *Taxing Times*, to Boot Camps, to webinars, the section relies on volunteers who donate their effort and countless hours of their time to support these opportunities. The Taxation Section is especially fortunate to have many "Friends of the Council" who lend their talents in myriad ways. Some of the Friends are former Council members, and others are tax attorneys, tax accountants, and other professionals who have a particular interest in the insurance space.

I'd like to take this opportunity to highlight one of our most dedicated volunteers, and the one who is least likely to toot his own horn. The Taxation Section, in an effort to stay on the cutting edge of technology, has taken a leadership role in developing podcasts for use in actuarial continuing education. Dan Theodore, of Milliman, is a former Council member and current Friend of the Council who recently completed his term. Dan has taken it upon himself to read aloud and record *Taxing Times* articles. He then edits the file, sends it to the author for review, and arranges to have it posted to the SOA website. Being somewhat technologically challenged myself, I was impressed that Dan could identify the right tools for producing a podcast (you just need a computer and a microphone… who knew?). Dan's initiative and hard work is greatly appreciated by the Section Council. The podcasts are available on iTunes or on the SOA website at *http://www.soa.org/Professional-Development/Event-Calendar/Podcasts/Taxation-Section.aspx.*

As always, we hope you enjoy this issue of *Taxing Times*. Please contact me or a member of the Editorial Board if you have any comments, ideas, or articles you would like to submit.

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amount."[4] MAGI is adjusted gross income, as that term is generally defined,[5] increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions allowed with respect to the foreign earned income).[6] The income thresholds are $250,000 for married couples filing jointly,[7] $125,000 for married couples filing separately,[8] and $200,000 for everyone else,[9] with none of these amounts being indexed for inflation in future years. Taxpayers with MAGI at or below the applicable income threshold are not subject to the tax, irrespective of their net investment income.

Section 1411(c) defines net investment income as (1) "gross income from interest, dividends, annuities, royalties, and rents," plus (2) any other gross income derived from a trade or business in which the taxpayer participates only passively or that is a business of trading in financial instruments or commodities, plus (3) net gain from dispositions of property to the extent taken into account in computing taxable income (subject to a special rule for property held in a non-investment business), minus (4) otherwise allowable deductions properly allocable to the foregoing. Hence, the new tax essentially aims to capture passive-type income items in its base, less certain deductions allocable to such income.

As we discussed in our September 2012 *Taxing Times* article, the new law raises questions regarding how section 1411 applies to insurance products. There have been questions, for example, as to the interpretation of the term "annuities." That term generally is not used in section 72, which contains the principal rules governing the income tax treatment of distributions from annuity contracts and pre-death distributions from life insurance contracts. The term does appear, however, elsewhere in the Code. For example, it appears in the section 61 list of the kinds of receipts generally includible in gross income (where it is listed separately from life insurance and endowment contract income) and also in sections 1441(b) (relating to the withholding of tax on nonresident aliens) and 6041(a) (defining the so-called "FDAP" income subject to withholding at source). In our prior article we explained why "gross income from … annuities" most likely would not encompass the undistributed "inside buildup" of annuity and life insurance contracts. This conclusion followed from the fact that the new tax applies only to amounts that constitute gross income, and the inside buildup is not even potentially includible in gross income until there has been a distribution from (or sale of) a contract.

On the other hand, we said in our prior article that we thought that "amounts received as an annuity" under annuity contracts —the amounts includible in gross income after applying the exclusion ratio under section 72(b)—clearly constitute investment income for purposes of the Investment Income Tax. At the same time, we were less certain that "gross income from … annuities" encompasses other distributions from an annuity contract, *i.e.*, "amounts not received as an annuity" under section 72(e). For example, we considered whether income from "annuities" would include partial distributions, loans, assignments, and dividends from annuity contracts, which amounts are generally includible in income to the extent of any income on the contract (and includible in full if received after the annuity starting date) as provided in the section 72(e) rules.

In our prior article, we were able to conclude that *some* distributions from annuity contracts likely would not be subject to the Investment Income Tax. For example, dividends retained by the insurer as premiums or other consideration paid for an annuity contract, which would include excess interest and earnings credits, are not includible in gross income and thus are not subject to the new tax. The rule in section 72(e)(4)(B) makes this clear. In addition, by virtue of section 72(e)(11), deemed distributions from annuity contracts to fund qualified

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long-term care insurance riders on such contracts do not constitute gross income, and thus they should not be viewed as gross income from "annuities" for purposes of the new tax. And, of course, qualified plan distributions are excluded from the base of the Investment Income Tax pursuant to the express rule in section 1411(c)(5).

Apart from the above, we noted that because distributions from life insurance and endowment contracts also are taxed under section 72, there could be questions about whether, or to what extent, the Investment Income Tax would apply to pre-death distributions from such contracts. Subsequently to the publication of our prior article, we have also encountered questions about whether the new tax would be accompanied by additional tax withholding and reporting requirements.[10]

PREAMBLE & PROPOSED REGULATIONS

When the Treasury Department and the IRS published proposed regulations last November on the application of the Investment Income Tax, the Notice of Proposed Rulemaking confirmed the conclusions and answered a number of the questions we noted in our prior article. Interestingly, however, the proposed regulations do not themselves provide a definition of "gross income from … annuities" or explain how annuity and life insurance contracts should be treated for purposes of calculating net gain from the disposition of property. Rather, it is the preamble to the proposed regulations (the "Preamble") that sheds light on some of the issues that we identified in our prior article. Accordingly, we now proceed to summarize below the Preamble's description of how the Investment Income Tax applies to insurance contracts.

Gross Income from "Annuities." The Preamble states that "[g]ross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e)." Based on the Preamble, the term "annuities" includes amounts received as an annuity, *i.e.,* annuitized payments, under not only an annuity contract but also a life insurance or endowment contract. However, with respect to amounts "not received as an annuity," the term "annuities" is more limited according to the Preamble, encompassing within the Investment Income Tax base only distributions under an annuity contract, and only to the extent they are includible in gross income pursuant to section 72(e). In other words, the new tax does not apply to the taxable portion of a withdrawal or other non-periodic distribution from a life insurance contract (including a modified endowment contract as defined in section 7702A) or an endowment contract. On the other hand, the new tax will apply to the taxable portion of *any* distribution from a non-qualified annuity contract, whether periodic or non-periodic. The exclusion of non-periodic distributions from life insurance and endowment contracts makes sense, since such distributions are not generally considered gross income from "annuities."

The Preamble confirms that amounts paid from annuity contracts that are includible in income pursuant to section 72(e), such as dividends, loans, and assignments, are included in the calculation of net investment income. In addition, it is clear from the Preamble that dividends retained by the insurer as premiums or other consideration paid for an annuity contract, and distributions from a contract to pay for a qualified long-term care insurance rider, are not treated as gross income from annuities because such amounts are not includible in income under section 72(e). Moreover, the Preamble confirms by implication that the Investment Income Tax does not apply to the undistributed inside buildup under an annuity, life insurance, or endowment contract.

Dispositions of Property. Section 1411(c)(1)(A)(iii) provides that net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property is also treated as net investment income for purposes of the Investment Income Tax. Thus, gain from the sale of an annuity or life insurance contract could be includible in net investment income. In the context of annuity contracts, the Preamble sets forth a rule allocating the gain from an annuity contract sale between "gross income from annuities" and net gain attributable to the disposition of property. In particular, it provides that to the extent the sales price of the annuity contract does not exceed the contract's surrender value, the net gain recognized (the sale proceeds less the seller's basis in the annuity) would be treated as gross income from annuities. If the sales price of the contract exceeds its surrender value, the seller would treat (1) the gain equal to the difference between the basis in the annuity and the surrender value as "gross income from annuities," and (2) the excess of the sales price over the surrender value as net gain from the disposition of property. In essence, the portion of the sales proceeds that does not exceed the contract's surrender value will be taken into account in determining gross income from annuities, and any excess of the sales proceeds over the surrender value will be taken into account as net gain from the sale or disposition of property.[11] Both amounts, however, will be subject to tax at the same 3.8 percent rate.

> Example. Assume that taxpayer owns an annuity contract with basis (or, investment in the contract) of $80 and a "surrender value" of $90. Assume further that taxpayer sells the contract for $100. Under the allocation rule described in the Preamble, the taxpayer would first allocate $10 ($90 surrender value - $80 basis) to "gross income from annuities." The taxpayer would allocate the remaining $10 ($100 sales price - $90 surrender value) to "net gain from the disposition of property."

An initial question regarding this allocation rule for annuity contracts is whether, as used in the Preamble, "surrender value" is intended to be a contract's cash value after the imposition of surrender charges and "basis" is intended to equal the contract's section 72(e)(6) "investment in the contract." Notably, the Preamble provides that "other than [certain] specific cross-references to provisions of chapter 1, and certain specific definitions set forth in section 1411, section 1411 does not provide definitions of its operative phrases or terminology. Moreover, there is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 would have the same meaning ascribed to it for other Federal income tax purposes (such as chapter 1)." After this warning, however, the Preamble goes on to observe that "[u]nder these proposed regulations, except as otherwise provided, chapter 1 principles and rules [which include section 72] apply in determining" the application of the new tax. The Preamble thus leaves somewhat unclear whether the terms "cash surrender value" and "investment in the contract" as used in section 72 would apply for purposes of determining a contract's "surrender value" and "basis," respectively, for purposes of the Investment Income Tax.

While the Preamble does not address the disposition of life insurance contracts, seemingly a sale of a life insurance contract is treated as a disposition of property for purposes of section 1411(c)(1)(A)(iii). Although the Preamble's allocation rule for the sale of an annuity contract by its terms does not extend to a disposition of a life insurance contract, it would appear that the rules for determining gain or loss on the sale of a life insurance contract should apply to determine net gain on the disposition of property (as we discussed in our prior article).[12] This would seem to have the same result as if the allocation rule for annuities did apply, based on the published guidance regarding life insurance sales.[13]

Losses on Annuity Contracts. Another question that could arise under the proposed regulations is whether or how losses on annuity contracts are reflected in the new tax. In certain cases, section 165 allows taxpayers to deduct losses on the surrender or sale of an annuity contract, subject to the 2 percent adjusted gross income floor.[14] In addition, section 72(b)(3) provides a deduction in certain cases where annuity payments cease before the taxpayer recovers his or her full investment in the contract. The Preamble and proposed regulations are not clear on how (or if) these deductions are taken into account when calculating net investment income. For example, they provide generally that loss deductions under section 165 can be taken into account only for purposes of determining net gain from the disposition of property, with the apparent implication that such loss deductions do not reduce "gross income from interest, dividends, annuities, royalties, and rents."[15] Moreover, the proposed regulations set forth what appears to be an exclusive list of specific deduction items that can be used to offset gross income from annuities, etc., but that list does not include section 72(b)(3).[16] Of course,

The FAQs state that the new tax is not subject to wage withholding, but they point out that taxpayers can request that additional amounts be withheld from their wages.

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if a taxpayer with MAGI above the applicable threshold owns but a single investment that is an annuity contract, no particular harm would arise if a loss on the contract could not be reflected in the calculation. However, it would seem that in most cases a taxpayer who incurs a loss on an annuity transaction also would have other investment income. It is in those cases that the proposed regulations lack clarity on how losses should be treated. Because the new tax purports to be one on "net" investment income, there should be some ability to reflect losses on annuity transactions, given that income from annuities is includible in the gross income base.

Withholding and Reporting. In connection with the publication of the proposed regulations on the Investment Income Tax, the IRS published some Frequently Asked Questions on section 1411 ("FAQs").[17] The FAQs address, among other topics, whether additional wage withholding will be required as a result of the Investment Income Tax. This is relevant to insurance companies because the wage withholding rules generally apply to periodic distributions from insurance contracts pursuant to section 3405(a). The FAQs state that the new tax is not subject to wage withholding, but they point out that taxpayers can request that additional amounts be withheld from their wages.[18] In addition, although not discussed in the FAQs, the legislation that enacted section 1411 did not amend the existing Code provisions applicable to the 10 percent withholding tax on non-periodic distributions from insurance contracts pursuant to section 3405(b). Accordingly, it appears that insurers can continue applying the withholding rules under current law to designated distributions they make under the contracts they issue. On the other hand, in late February one change appeared in the applicable tax reporting instructions. According to page 1 of the instructions for the 2013 Form 1099-R, reporting payors must "[u]se Distribution Code D to identify nonqualified annuity payments that may be subject to tax under section 1411." This code is to be reported in box 7 of the form.

Qualified Plans. Section 1411(c)(5) provides that net investment income "shall not include any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b)." The proposed regulations, along with the Preamble, confirm that net investment income does not include distributions from qualified retirement plans, IRAs, and section 457(b) plans. The proposed regulations provide examples on a variety of situations in which such distributions are not treated as net investment income subject to the new tax, including rollovers, deemed distributions and corrective distributions of excess contributions, and Roth conversions. The Preamble notes, however, that taxable qualified plan distributions are included in the taxpayer's MAGI for purposes of applying the thresholds.

Effective Date. The Treasury and the IRS have requested comments on the proposed regulations and have scheduled a public hearing. According to the Preamble, the agencies intend to finalize the regulations this year. The proposed regulations would generally be effective for taxable years beginning after Dec. 31, 2013, although section 1411 is already effective, applying for taxable years beginning after Dec. 31, 2012. In this regard, the Preamble states that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Interestingly, the Notice of Proposed Rulemaking and the FAQs say nothing about relying on the Preamble itself, leaving taxpayers and insurers with some question about the degree of comfort (or not) that they can take away from the guidance.

CONCLUSION

The proposed regulations and, more specifically, the Preamble endeavor to provide some clarification as to the application of the Investment Income Tax to contracts issued by life insurers. They furnish responses to a good many questions that life insurers have had regarding the scope of gross income from "annuities," although, as is often the case with formal guidance, some questions remain open. Life insurers have learned to live with a relative paucity of guidance when it comes to the federal tax treatment of their products, and so reading and attempting to follow observations made in the Preamble rather than specific regulatory rules will not be a new experience for them.

END NOTES

[1] References to "section" are to sections of the Internal Revenue Code of 1986, as amended ("Code").
[2] 77 Fed. Reg. 72612 (Dec. 5, 2012). The government released an advance version of the proposed regulations on Nov. 30, 2012, and the official version was published in the Federal Register five days later.
[3] Pub. L. No. 111-152, § 1402(a)(1).
[4] Section 1411(a)(1).
[5] *See* section 62.
[6] Section 1411(d).
[7] Section 1411(b)(1).
[8] Section 1411(b)(2).
[9] Section 1411(b)(3).
[10] *See* section 3405.
[11] This division is comparable to the one set forth in Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, in the case of the sale of a life insurance contract.
[12] *See* Rev. Rul. 2009-13, *supra* note 11 (holding, *inter alia*, that sections 1001, 1011 and 1012 apply in determining the amount a taxpayer must recognize in gross income upon the sale of a life insurance contract).
[13] *See id.*
[14] *See* IRS Pub. 575, Pension and Annuity Income, at 22 (2012) (a "loss under a nonqualified plan, such as a commercial variable annuity, is deductible…").
[15] *See* Prop. Treas. Reg. § 1.1411-4(f)(4) (stating that the allowable deductions "do not include losses described in section 165, whether described in section 62 or section 63(d). Losses deductible under section 165 are deductible only in determining net gain under paragraph (d) of this section, and only to the extent of gains.")
[16] We note that one deduction item that the list does include is section 62(a)(9). *See* Prop. Treas. Reg. § 1.1411-4(f)(2)(iii). Section 62(a)(9) provides above-the-line treatment for certain loss deductions under section 165 that otherwise would be miscellaneous itemized deductions (specifically, certain losses relating to early withdrawal fees on CDs and similar timed deposits). Because section 62(a)(9) merely changes the status of a section 165 deduction, its inclusion in the list of allocable deduction items under the proposed regulations would appear to run contrary to the general rule, described above, that prohibits the use of section 165 deductions for any purpose other than calculating "net gain" from dispositions of property.
[17] *See* http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.
[18] Under current law the wage withholding rules allow a taxpayer to elect a dollar amount to be withheld in addition to the amount of withholding based on filing status and withholding allowances claimed on IRS Form W-4, *Employee's Withholding Allowance Certificate*.

ERRONEOUS TAX RESERVE COMPUTATIONS —YEAR OF CORRECTION

By Peter H. Winslow

A question that frequently arises is whether a life insurance company is permitted, or required, to retroactively correct a tax reserve error that has been made in a previously filed tax return. The answer to this question may depend upon the type of reserve error that has been made. For purposes of analysis, it is useful to classify errors into four general categories:

- Mathematical or posting errors
- I.R.C. § 807(d)[1] errors
- Judgmental errors
- Statutory reserve compliance errors.

Before analyzing the consequences of these four types of errors, a review of the basic tax reserve rules that come into play is warranted. Under I.R.C. § 807(d), most life insurance reserves are required to be computed in accordance with the tax reserve method prescribed by the NAIC in effect on the date of issuance of the contract. The tax reserve method for life insurance contracts is CRVM for contracts covered by CRVM, and for annuity contracts it is CARVM for contracts covered by CARVM. For contracts not covered by CRVM or CARVM, the reserve method prescribed by the NAIC as of the date of contract issuance must be used, or, if no method has been prescribed, a reserve method consistent with whichever of the prescribed methods is most appropriate must be used. In applying the tax reserve method, federally prescribed interest rates and prevailing state mortality tables also are required to be used, again, usually determined as of the issue date of the contract. The reserve is then capped by statutory reserves and floored by the net surrender value determined on a contract-by-contract basis. Where particular assumptions, other than interest or mortality, are not prescribed by the NAIC method, the legislative history states that, in general, life insurance reserves are computed by using assumptions made for statutory reserves.

A special rule may apply when a life insurance company changes its basis of computing reserves to correct an error. I.R.C. § 807(f) imposes a "10-year spread" under which the difference between the tax reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change is reflected ratably over 10 years.[2] The 10-year spread rule of I.R.C. § 807(f) is applicable only when there otherwise would have been a change in method of accounting under general tax law principles.[3]

MATHEMATICAL OR POSTING ERRORS

Under the general provisions of the Internal Revenue Code and regulations relating to accounting methods, a mere mathematical or posting error is not a change in method of accounting.[4] Therefore, this type of error is not subject to the 10-year spread rule of I.R.C. § 807(f). The IRS takes the position that most corrections to tax reserves are in the nature of a change in method of accounting and very few situations fall into the category of correction of an error. The IRS has stated that corrections of an error are limited to situations where there are pure mathematical or posting mistakes, such as a defect in the computer program for computing reserves.[5] For example, omitting certain contracts in computing reserves could be considered an error.[6]

The Internal Revenue Code does not impose a duty on a taxpayer to file an amended return for a prior year to correct errors when the original return was filed in good faith. Nevertheless, as a practical matter, a failure to file an amended return to correct a material tax reserve error, or to disclose the error at the outset of an audit, could expose the company to accuracy-related penalties. In Rev. Rul. 94-74,[7] the IRS stated that a life insurance company "should" file an amended return to correct mathematical or posting errors.

When a mathematical error results in an inappropriate understatement of tax reserves, it is particularly important to correct the error in the earliest open year. Otherwise, there could be a permanent loss of a deduction. There is nothing in the tax law that permits the opening tax reserve balance for the year following the reserve error to carry over the prior year's closing reserve mathematical error. Both opening and closing tax reserves for the current year must be computed correctly.

As a result, it is possible that a deduction for the amount of the mathematical error could never be deductible unless the correction is made for the year the error, in fact, was made.

I.R.C. § 807(d) ERRORS

An error made in applying the tax reserve method, the interest rate or mortality table prescribed by I.R.C. § 807(d) almost always is a change in basis of computing reserves. This type of error affects the timing of recognition of the company's liability for benefits and would be a change in method of accounting but for the application of I.R.C. § 807(f). Because I.R.C. § 807(d) prescribes these tax reserve computational requirements, and consent of the IRS is not a precondition to changing to a proper method that complies with I.R.C. § 807(d), either the IRS or the company can insist that the tax reserve error be corrected in the earliest open year.[8] It appears, however, that the IRS does not believe that a retroactive correction is mandatory. Situation 1 of Rev. Rul. 94-74 described a situation where the company used an incorrect mortality table in computing tax reserves for reinsured contracts. The IRS concluded that the company "may" recompute its tax reserves for the earliest open year, implying that it was not required to do so. Presumably, this means that the company could choose to correct the error prospectively on the next return to be filed. Nevertheless, if the error is material and a failure to correct it retroactively would result in a substantial overstatement of tax reserve deductions, disclosure of the error at the outset of an IRS audit for the earlier year would be advisable to avoid penalties because the IRS can insist on a correction.[9]

JUDGMENTAL ERRORS

Tax reserve assumptions that are not specified by I.R.C. § 807(d) (*i.e.*, assumptions other than the tax reserve method, interest and mortality) should conform to the factors used for statutory reserves. As a result, when assumptions used for statutory reserves change, a conforming change usually should be made for tax reserves if the assumptions are not otherwise dictated by I.R.C. § 807(d). Material changes to tax reserve assumptions are subject to the 10-year spread rule of I.R.C. § 807(f).[10] Sometimes tax reserve assumptions set by actuarial discretion may not be grounded in statutory reserves. That is, an actuary may have to make an assumption in computing tax reserves even though statutory reserves are computed on a different basis. This could occur, for example, when statutory reserves are not computed using the tax reserve method required by I.R.C. § 807(d). Another instance when tax assumptions may be independent of statutory reserves could occur where mortality tables are "adjusted as appropriate" under I.R.C. § 807(d)(1) to reflect risks not considered in prevailing commissioners' standard tables.[11]

In these situations, circumstances could arise when the company decides that the tax reserve assumptions previously made were inappropriate and seeks to correct tax reserves to more accurately reflect the reserve liabilities. Can the company make the correction retroactively on a previously-filed return? The answer depends on whether the original assumption was an appropriate exercise of judgment at the time the tax reserve initially was established. If it was appropriate at the outset, the tax reserve cannot be corrected retroactively to reflect more accurate information that subsequently became available.[12] On the other hand, if the tax reserve computation contained an assumption that was unreasonable when it was made, or failed to reflect risks that should have been considered, correction can be made for the earliest open year even though this is not a mathematical error.[13] If the inappropriate assumption was made consistently for a series of years, however, a correction would still be subject to the 10-year spread rule of I.R.C. § 807(f).

STATUTORY RESERVE COMPLIANCE ERRORS

What if the reserve error was not made solely with respect to the federally prescribed reserves under I.R.C. § 807(d), but was made with respect to statutory reserves? Can a corrective change be made retroactively for purposes of determining the statutory reserves cap on tax reserves? Again, the answer depends on the type of statutory reserve error.

Where the statutory reserve error is merely the geography of where the reserve was reported on the Annual Statement or how it was labeled, the liability nevertheless should be included in statutory reserves for purposes of the contract-by-contract reserve comparison. From a tax perspective, this is not an error in the first place. The IRS has ruled that the fact that the reserves are not treated as life reserves on the Annual Statement is immaterial for federal income tax purposes.[14]

Statutory reserve errors that are improper because they violate the Standard Valuation Law are problematic. I.R.C. § 807(d)(6) provides that the term "statutory reserves" means the aggregate amount "set forth in the annual statement" with respect to reserve items for the contract. The IRS may argue that this statutory language precludes statutory reserves from being retroactively corrected to increase the statutory reserves

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cap. Despite this likely IRS position, it may be possible to correct improper statutory reserves and have them taken into account in the statutory reserves cap if steps are taken to acknowledge to insurance regulators that an error has been made in the Annual Statement and corrective action is taken. Statutory reserves reported on a refiled Annual Statement probably should be respected for tax purposes when the refiling was necessitated by statutory reserve errors.

Another situation that could cause a problem is a pure mathematical error that is made in statutory reserves. For example, suppose a computer error omits a class of policies and no statutory reserves are held. In this situation, it may be possible to fix statutory reserves for tax purposes to correct the mathematical or posting error whether or not the error is sufficiently material to warrant a refiling of the Annual Statement. This would have been the result under pre-1984 tax law when statutory reserves were required to be "held" in order to be deductible.[15] The same result may apply for purposes of the statutory reserves cap, even though technically the reserves must be "set forth in the annual statement" to be included in statutory reserves.

CONCLUSION

The lesson to be learned from this summary of the law relating to tax reserve errors is that in the majority of situations a retroactive correction in the earliest open year is permissible, if not required. In some circumstances, this probably should even apply to statutory reserves. Where an error has resulted in smaller deductions than otherwise should have been allowed, and tax reserves are growing, it is almost always better to pursue a retroactive correction. A retroactive fix can minimize the 10-year spread amount under I.R.C. § 807(f), or prevent a permanent loss of a deduction in the case of a mathematical error. Conversely, if the error overstated tax reserves in prior years or if the amount of tax reserves is declining, it usually is better to correct the error on the next tax return to be filed. It must be recognized, however, that without adequate disclosure this approach could expose the company to accuracy-related penalties because the IRS has the authority to require the error to be remedied in the earliest open year.

END NOTES

1 "I.R.C. §" refers to a section of the Internal Revenue Code of 1986, as amended.

2 For a detailed discussion of I.R.C. § 807(f), *see* Winslow & Jones, *Change in Basis of Computing Reserves—Is It or Isn't It?* 9 TAXING TIMES, Vol. 6, Issue 1 (Feb. 2010).

3 *See* Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life & Accident Ins. Co. v. U.S.*, 71A A.F.T.R. 2d 93-3319 (M.D. Tenn. 1989).

4 Treas. Reg. § 1.446-1(e)(2).

5 IRS Coordinated Issue Life Insurance Industry, *IRS Section 807 Basis Adjustments Change in Basis v. Correction of Error* (Jan. 6, 1997).

6 Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.

7 1994-2 C.B. 157.

8 *Id.*, Situations 1 and 2.

9 *Id.*, Situation 2.

10 *Id.*, Situation 3.

11 PLR 9251005 (Sept. 9, 1992).

12 *Pacific Mutual Life Ins. Co. v. Comm'r,* 48 T.C. 118 (1967), *rev'd on another issue*, 413 F.2d 55 (9th Cir. 1969); Rev. Rul. 69-302, 1969-1 C.B. 186.

13 PLR 9251005 (Sept. 9, 1992).

14 Rev. Rul. 70-34, 1970-1 C.B. 149.

15 G.C.M. 39516 (June 10, 1986).

IRS RELEASES NEW RULING ON BOLI PARTNERSHIP

By John T. Adney and Bryan W. Keene

In late February, the Internal Revenue Service (IRS) released PLR 201308019,[1] addressing the treatment of a partnership formed to hold and manage bank-owned life insurance (BOLI) policies. The facts and issues involved in the new ruling share certain similarities with those involved in a private letter ruling from 2011, on which we reported in the May 2012 issue of *Taxing Times*.[2] Both rulings address federal income tax issues presented by the transfer of BOLI policies by unrelated banks to a new partnership and the ongoing operation of the partnership. The biggest difference between the transactions is that, in the earlier ruling, the partnership intended to exchange most or all of the policies contributed to it, whereas in the new ruling the partnership would not exchange any of the policies. As a result of this factual difference, the tax and non-tax regulatory implications of the arrangements also differed somewhat.

FACTS INVOLVED IN PLR 201308019

The transaction in PLR 201308019 involves a limited liability company (the "Company") that intends to be treated as a partnership for federal income tax purposes. Two unrelated banks, A and B, propose transferring some of their existing BOLI policies to the Company in return for percentage interests in the Company. The policies are general account (*i.e.*, non-variable) life insurance contracts that insure the lives of individuals who, at the time first covered, were employees, officers or directors of the two banks or their affiliates.

Each of the two banks will irrevocably assign all its ownership rights in the policies to the Company. In return, the banks will receive percentage interests in the Company based on the relative fair value of the policies they contribute. The Company will accept additional contributions of policies from the initial two banks and other unrelated banks for up to two years from the date the first policies are contributed. If such additional contributions occur, the Company will adjust the bank-partners' percentage interests accordingly.

The Company will engage in the business of managing the policies for the benefit of the bank-partners. A non-bank "Managing Member" will enjoy broad discretion in controlling the Company's activities. Those activities could include (1) exercising all rights under the policies, (2) interacting with regulators to facilitate compliance with any applicable banking laws, and (3) collecting the policies' death benefits and distributing them to the bank-partners. As compensation, the Managing Member will receive a fee based on the fair value of the Company's policies. This fee will be funded through the Company's cash flows, which will consist primarily of death benefits it receives from the policies. The Managing Member will treat all amounts it receives as taxable compensation, even if the Company funds a payment to the Managing Member using the policies' otherwise tax-exempt death proceeds.

Although the Managing Member will hold broad discretion in exercising the Company's rights with respect to the policies, the Company does not intend to engage in exchanges of the policies or to acquire additional policies other than through banks transferring them to the Company as partnership contributions. As the Company receives death benefits under the policies, it will allocate the proceeds, net of Company expenses, to the bank-partners based on their percentage interests. According to the ruling, the bank-partners will likely want to retain their interests in the Company because those interests will have significant value and will fund the banks' employee benefit liabilities. The ruling also says, however, that bank-partners may need to dispose of their percentage interests in some cases, such as in a liquidity emergency or at the direction of a bank regulator. To facilitate this, the bank-partners will be allowed to sell their interests in the Company to other banks, with the replacement banks thereby succeeding to all attendant benefits and burdens of those interests. The Company also will retain the right to purchase outstanding interests from the bank-partners at negotiated prices, but generally will not offer a redemption right.

ISSUES ADDRESSED IN PLR 201308019

PLR 201308019 addresses the Company's treatment as a partnership as opposed to an investment company, which

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The transfer for value rule is a limitation on the income tax exclusion that life insurance death benefits otherwise enjoy.

has implications for how the "transfer for value rule" of section 101(a)(2) applies to the policies the Company holds.[3] In the 2011 ruling noted above, the IRS also addressed this aspect of the partnership tax rules, although the 2011 ruling did not elaborate on the implications of that conclusion for the transfer for value rule. In contrast, PLR 201308019 expressly addresses those implications, concluding that the banks' transfer of policies to the Company will not trigger the transfer for value rule. In addition, unlike the 2011 ruling, PLR 201308019 addresses how the transfer for value rule applies to a bank's sale or exchange of its partnership interest in the Company to another bank, concluding that the transaction will not amount to a transfer of the policies themselves for purposes of that rule.

With respect to the partnership tax issue, the new ruling concludes that no gain or loss will be recognized pursuant to section 721 upon the transfer of a policy by a bank to the Company in exchange for a percentage interest in the Company. As a general matter, under section 721(a) no gain or loss is triggered when a person acquires a partnership interest by transferring property to the partnership. Section 721(b) overrides this rule, however, if the partnership would be treated as an investment company within the meaning of section 351 if it were incorporated. In such cases, sections 721(b) and 351 operate to tax property when contributed to a partnership. By concluding that the normal section 721 rules, and not the investment company rules, will apply to the banks' transfers of policies to the Company, the ruling confirms that the policies can be transferred to the Company tax-free.

As is sometimes the case with private letter rulings, PLR 201308019 provides little analysis in stating its conclusion under section 721(b). We note, however, that to be treated as an investment company for purposes of that section, the Company would need to meet several requirements, including having more than 80 percent of its assets comprised of stock and securities.[4] When addressing this issue in the 2011 ruling, the IRS reasoned that because the partnership's assets would consist solely of life insurance policies and some cash, its assets would not be comprised of stock and securities.[5] Presumably, the IRS relied on a similar analysis in PLR 201308019. Indeed, the conclusion may have been easier to reach in the new ruling, considering that the 2011 ruling involved both variable (separate account) and fixed (general account) life insurance policies, whereas the new ruling involved only fixed policies.

The new ruling's conclusion under section 721(b) also helps clear the path for its second important conclusion: that the transfer for value rule will not apply when banks contribute their policies to the Company. The transfer for value rule is a limitation on the income tax exclusion that life insurance death benefits otherwise enjoy. Pursuant to section 101(a)(1), such benefits normally are tax-free when received by the beneficiary, and, if the beneficiary is a partnership, the death benefits remain tax-free when passed through to the partners. Under the transfer for value rule of section 101(a)(2), however, if a life insurance policy is transferred "for a valuable consideration," the income tax exclusion is limited to the consideration and any subsequent premiums that the transferee paid for the policy.

Since, under the facts of the new ruling, the banks will receive valuable consideration (namely, interests in the Company) in return for transferring their policies to the Company, the transfer for value rule would apply in the absence of any exception. One exception is for "carryover basis," *i.e.*, where the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis.[6] PLR 201308019 concludes that this exception will apply to the banks' transfers of policies to the Company, making the transfer for value rule inapplicable and ensuring that the policies' death benefits will be tax-free when the Company, and ultimately each bank-partner, receives them. This conclusion was facilitated, in part, by the conclusion above that the partnership tax rules would not operate to tax the gain in the policies at the time of the transfer, thereby allowing the normal carryover basis rules under the partnership tax regime to govern the transaction.[7]

The new ruling also addresses the application of the transfer for value rule to another aspect of the transaction, namely, a bank's potential future sale or exchange of its partnership interest in the Company. The concern apparently was that such a transaction might be viewed as a sale or exchange of the life insurance policies that the Company holds, thereby triggering the transfer for value rule with respect to the policies. The ruling confirms that this will not be the case, as long as the sale or transfer of the partnership interest in the Company does not result in a termination of the Company within the meaning of section 708(b)(1)(B), which would result in a deemed distribution of the Company's assets to its partners.[8]

The ruling provides little analysis in connection with the foregoing conclusion. We note, however, that as a general matter subchapter K represents a blending of "aggregate" and "entity" theories in prescribing the rules that govern the federal income taxation of partnerships. Under the "aggregate" theory, a partnership is merely a conduit for its individual partners, each of whom is deemed to own a direct undivided interest in partnership assets and operations. Under the "entity" theory, a partnership is an entity separate from its partners, such that the partners are not deemed to have a direct interest in partnership assets or operations, but only an interest in the partnership entity separate and apart from its assets and operations. Section 741 generally adopts an entity approach for transfers of partnership interests, in that it provides that the sale or exchange of a partnership interest will result in recognition of gain or loss to the transferor partner, with the character of the gain or loss being capital in nature unless otherwise prescribed by section 751. Thus, the general rule is that the partnership interest itself is the property that is sold or exchanged in a transfer of a partnership interest to a third party, *i.e.*, the entity theory generally controls. The IRS has followed this approach in at least one other private letter ruling in which it concluded that a sale of a partnership interest would not trigger the transfer for value rule with respect to life insurance policies the partnership owned.[9]

CONCLUDING THOUGHTS

PLR 201308019 reaches favorable conclusions on the treatment of the BOLI arrangement under the partnership tax rules of section 721 and the transfer for value rule of section 101(a)(2). While the arrangement is similar to one the IRS addressed in a 2011 private letter ruling, the new arrangement would seem to present fewer issues from a tax and non-tax regulatory perspective. In particular, the new arrangement does not contemplate the Company engaging in any exchanges of the life insurance policies it holds, whereas such policy exchanges were a key component of the arrangement described in the 2011 ruling. The intent to engage in such policy exchanges in the 2011 ruling led the parties to seek guidance from the IRS on the implications under 264(f), which denies interest expense deductions for BOLI owners in certain cases, and section 101(j), which denies the otherwise applicable income tax exclusion for BOLI death benefits in certain cases. Although the IRS reached favorable determinations on those additional issues in the 2011 ruling, there was no need to address them in PLR 201308019. Likewise, for the parties to the new transaction, there would appear to be no need to address some of the non-tax regulatory issues we mentioned in our May 2012 article, such as whether and how state insurable interest and notice and consent laws apply in the context of a policy exchange. ◂

END NOTES

1 The IRS issued PLR 201308019 on Aug. 23, 2012, and released it to the public on Feb. 22, 2013.

2 *See* John T. Adney and Bryan W. Keene, "IRS Rules on New BOLI Arrangement," *Taxing Times*, May 2012, Vol. 8, Issue 2 (discussing PLR 201152014 (Sept. 22, 2011)).

3 Unless otherwise indicated, each of our references to a "section" means a section of the Internal Revenue Code of 1986, as amended.

4 *See* section 351(e) and Treas. Reg. section 1.351-1(c)(1)(ii).

5 PLR 201152014.

6 Section 101(a)(2)(A).

7 Rev. Rul. 72, 1953-1 C.B. 23 (concluding that the carryover basis exception to the predecessor provision of section 101(a)(2) applied to the contribution of a life insurance contract to a partnership because the partnership tax rules provide for a carryover basis with respect to property contributed to a partnership).

8 Section 708(b)(1)(B) provides that a partnership will be considered terminated if, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If a partnership is terminated, its assets generally are deemed distributed. *See, e.g.*, Rev. Rul. 99-6, 1999-1 C.B. 432.

9 PLR 200826009 (Dec. 20, 2007).

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ARE RESERVES FOR BAD FAITH CLAIMS DEDUCTIBLE BY A LIFE INSURANCE COMPANY?

By Peter H. Winslow

In an important decision for insurance companies, the Seventh Circuit held in *State Farm*[1] that extra-contractual obligations ("ECOs") of a property/casualty company that are claims-related compensatory damages (*e.g.*, bad faith claims) are properly included in deductible unpaid losses under I.R.C. § 832(b)(5).[2] State Farm had included a $202 million award of compensatory and punitive damages (and related interest) in its loss reserves on its annual statements and tax returns for 2001 and 2002. On audit, the IRS disallowed the loss reserve deduction arguing that the damages did not arise as claims under an insurance contract and, therefore, should be deducted on an accrual basis in the same manner as other contested liabilities. The Tax Court agreed with the IRS's position, holding that the damages were not losses incurred "on insurance contracts" as required by I.R.C. § 832(b)(5).[3]

In the Tax Court litigation, neither the parties nor the court made any distinction between compensatory ECOs and punitive damages. This situation changed on appeal in the Seventh Circuit. Several property/casualty insurance trade associations jointly filed an amicus brief with the court in which they argued that statutory accounting principles distinguish between compensatory ECOs and punitive damages. Claims-related compensatory ECOs are properly included in losses, *i.e.*, treated for accounting purposes as claims. Relying on the amicus brief, the Seventh Circuit reversed the Tax Court's decision as it related to compensatory ECOs but upheld the lower court denying a loss reserve deduction for contested punitive damages.

The Seventh Circuit's opinion has received a lot of attention because of its rejection of the IRS's position on a fundamental principle of insurance company taxation. The Internal Revenue Code provisions governing property/casualty insurance company taxation defer to NAIC accounting for computation of underwriting income. The IRS's position is that the Code's deference to NAIC accounting does not encompass the types of items that are taken into account in underwriting income for federal income tax purposes; the Code only defers to annual statement accounting once the elements of underwriting income are determined by interpreting the Code and regulations. In the case of ECOs, the IRS pursued its position arguing that NAIC accounting guidance is irrelevant and that claims-related compensatory ECOs cannot be characterized as insurance claims. The IRS contended ECOs flunk a threshold tax test for loss reserve treatment—ECOs are not losses incurred "on insurance contracts."

The Seventh Circuit rejected the IRS's narrow interpretation of the Code's deference to NAIC accounting principles. The court noted that the statute requires the use of NAIC annual statement accounting for underwriting income generally, and for unpaid losses specifically. The court concluded that, to the extent the NAIC has dictated that claims-related compensatory ECOs are required to be included in underwriting income as part of losses incurred, there is no room in the statute for the IRS to second-guess the NAIC and contend that particular classes of losses are not "on insurance contracts" within a non-NAIC tax definition imposed by I.R.C. § 832(b)(5). In other words, the deference to NAIC accounting broadly includes the measurement of underwriting income as a whole, not just the timing of particular items once the items included in underwriting income are determined by tax law.

Although *State Farm* dealt only with property/casualty insurance companies, and only with the Code provisions that govern their taxation, the Seventh Circuit's decision has potentially significant ramifications for life companies. For example, the case presents the general proposition that when deference to the NAIC is required by the Internal Revenue Code, that deference must be respected by the IRS. Thus, the court's holding calls into question whether the IRS has the authority under I.R.C. § 807(d) to require federally prescribed tax reserves of life insurance companies to be computed using any version of CRVM or CARVM that is inconsistent with NAIC guidance. In this regard, the Seventh Circuit's opinion complements the holding of the Sixth Circuit in *American Financial*[4] that similarly rejected the IRS's attempt to depart from NAIC guidance in interpreting CARVM for annuity contracts.[5]

More specifically, the *State Farm* case might support a conclusion that claims-related compensatory ECOs (*e.g.*, bad faith claims) are deductible on a reserve basis by life insurance companies. Let's walk through the analytical steps.

> Step One: Annual Statement accounting treatment for ECOs is the same for property/casualty and life companies.

Statement of Statutory Accounting Principles ("SSAP") No. 55 establishes statutory accounting principles for liabilities for unpaid claims and loss adjustment expenses not only for property/casualty insurance contracts, but also for claims and related expenses under life insurance and accident and health contracts. The general rule of SSAP No. 55 is that claims, losses and loss adjustment expenses are recognized on an estimated basis when a covered or insured loss event occurs. For life and accident and health contracts, liabilities for claims include reasonable estimates of due and unpaid claims; resisted and other claims in the course of settlement, either in the full amount of the claim or a percentage of the claim based on past experience with similar claims; and incurred but not reported claims.

In 2003, the NAIC Emerging Accounting Issues Working Group issued INT 03-17 dealing with ECOs. INT 03-17 concludes that claims-related ECOs, including bad faith losses other than punitive damages, are required to be included in losses in accordance with SSAP No. 55. By its terms, INT 03-17 applies to all lines of business, including life and accident and health insurance. Although INT 03-17 does not state the rationale for its conclusion, presumably the NAIC working group determined that the origin of the liability for ECOs is an explicit or implicit contractual duty of the insurer to settle claims in good faith, and to the extent compensatory damages arise from a breach of that duty, they are properly classified as claims arising under the insurance contract.

In summary, life insurance companies are treated just like property/casualty companies with respect to statutory accounting for ECOs; NAIC annual statement accounting requires that a liability be established for estimated potential claims-related ECOs at the time a claim is incurred. This is so even if the liability for ECOs is contested and even though the potential liability for ECOs may exceed the coverage limits in the policy.

> Step Two: Tax treatment of contested claims is the same for property/casualty and life companies.

In general, I.R.C. § 811(a) places life insurance companies on an accrual method of accounting. However, I.R.C. § 811(a) also provides that:

> To the extent not inconsistent with [accrual accounting] or any other provision of this part, 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.

This provision has been interpreted to mean that NAIC accounting rules control so long as they are not inconsistent with accrual accounting.[6] That is, where a particular item has no counterpart in accrual accounting, such as life insurance reserves, NAIC accounting standards apply.[7]

Two provisions of the Code allow for a deduction of estimated unpaid claims by life insurance companies. The first provision is I.R.C. § 805(a)(1) that provides a deduction for "All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts." I.R.C. § 805(a)(2) also allows a deduction for increases in reserves under I.R.C. § 807(b), which by cross-references to I.R.C. § 807(c) and 816(c)(2) includes "unpaid losses (whether or not ascertained)."[8] The regulations make it clear that the reference to "unpaid losses (whether or not ascertained)" in these sections has no counterpart in accrual accounting. After first describing "accrued" claims, Treas. Reg. § 1.809-5(a)(1) goes on to say that "losses incurred (whether or not ascertained) ... includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year." Consequently, as a reserve item that does not depend on accrual accounting, claims (whether or not ascertained) are accounted for by life insurers in a manner consistent with NAIC statutory principles. Moreover, just as the Seventh Circuit in *State Farm* concluded that compensatory ECOs are claims "on insurance contracts" within the meaning of I.R.C. § 832(b)(5) for P/C companies, in the life insurer context, a court is equally likely to conclude that compensatory ECOs are likewise "on insurance and annuity contracts" within the meaning of I.R.C. § 805(a). In summary, it is reasonable to conclude that

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Life insurance companies are treated just like property/casualty companies with respect to statutory accounting for ECOs.

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because (1) "unpaid losses (whether or not ascertained)" for life companies are not subject to accrual accounting, (2) I.R.C. § 811(a) defers to the NAIC accounting method for this item, and (3) under INT 03-17 claims-related compensatory ECOs are included as part of claims in annual statement accounting, claims-related compensatory ECOs should be deductible on an estimated basis under I.R.C. § 805(a)(1) or (2) under the reasoning of *American Financial* and *State Farm*, at least by companies domiciled in the Sixth and Seventh Circuits.

Such a conclusion may surprise some insurance company tax practitioners, who generally are aware of important differences in the deductibility of expenses by property/casualty and life insurance companies. In particular, even though NAIC accounting principles (SSAP No. 55) require both types of insurers to report loss adjustment expenses on an estimated basis, life insurance companies are required to account for these expenses on an accrual basis at least for their life insurance lines of business.[9] A different rule applies to property/casualty companies which can include an estimate of unpaid loss adjustment expenses as part of unpaid losses under I.R.C. § 846(f)(2). However, there is an important difference between ECOs and loss adjustment expenses. The NAIC has determined in INT 03-17 that ECOs are claims and not merely costs of administering claims. As such, compensatory ECOs should be deductible by life insurance companies on an estimated basis as part of unpaid losses unless the IRS can convince another court that the Seventh Circuit was wrong in *State Farm*. However, unlike property/casualty companies, life insurers would need to bifurcate their SSAP No. 55 liability for ECO costs between compensatory damages and administrative expenses. Only the portion attributable to estimated damages would be deductible on a reserve basis for life insurance lines of business.

END NOTES

1 *State Farm Mutual Automobile Ins. Co. v. Comm'r*, 698 F.3d 357 (7th Cir. 2012).

2 "I.R.C. §" refers to a section of the Internal Revenue Code of 1986, as amended.

3 *State Farm Mutual Automobile Ins. Co. v. Comm'r,* 135 T.C. 543 (2010).

4 *American Financial Group v. U.S.,* 678 F.3d 422 (6th Cir. 2012).

5 For a detailed analysis of the *American Financial* case, *see* Peter Winslow, *The Sixth Circuit Gets it Right in American Financial—an Actuarial Guideline Can Apply to Prior Contracts When the Interpretation Was a Permissible Option at the Time the Contract Was Issued*, Society of Actuaries Taxation Section, 21 *Taxing Times*, Vol. 8, Issue 3 (Oct. 2012).

6 General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of Joint Comm. on Taxation, H.R. 4170, 98th Cong., Pub. L. 98-369, at 621.

7 *Commissioner v. Standard Life and Accident Ins. Co.*, 433 U.S. 148 (1977).

8 The seemingly duplicative deductions for unpaid losses are remedied by I.R.C. § 811(c) which provides that the same item cannot be counted twice.

9 *See* Peter Winslow, *Loss Adjustment Expenses for Life Insurance Companies,* Society of Actuaries Taxation Section, T^3: *Taxing Times* Tidbits, 40 *Taxing Times*, Vol. 7 Issue 3 (Sept. 2011).

AMERICAN TAXPAYER RELIEF ACT OF 2012—ACTIVE FINANCING INCOME EXCEPTION TO SUBPART F

By James A. Sabella and Edward Clabault

On Jan. 2, 2013, President Barack Obama signed into law the American Taxpayer Relief Act of 2012 ("The Act"). The Act included numerous individual tax provisions as well as a retroactive extension of certain business tax provisions that had been allowed to expire. Of particular note to the insurance industry were the extensions, through Dec. 31, 2013, of the exception in Subpart F allowing deferral of the income of a controlled foreign corporation ("CFC") engaged predominantly in the active conduct of a Banking, Financing or Similar Business (widely referred to as the Active Financing Exception, or "AFE"—see rules contained in Internal Revenue Code §953(e) and §954(i)), and the look-through rule for payments between related CFCs—see rules contained in §954(c)(6).

Under the AFE, certain underwriting and investment income will not constitute Subpart F income if a "qualifying insurance company" CFC and/or a "qualifying insurance company branch" is operated in a manner consistent with the provisions of sections 953(e) and 954(i).[1] This exclusion from Subpart F treatment can result in significant tax deferral for U.S. groups that have organized their overseas insurance operations with the AFE in mind. In conjunction with excluding certain home-country underwriting income, the AFE provides an additional exclusion for certain underwriting income attributable to cross-border business written through a qualifying insurance branch, and finally, for deferral of certain investment income attributable to insurance operations. Under §953 in effect prior to the initial enactment of AFE (AFE became effective for taxable years of a foreign corporation beginning after Dec. 31, 1998), neither of these additional deferral opportunities were available.

The CFC look-through rule contained in §954(c)(6) provides an exemption from Subpart F treatment for dividends, interests, rents and royalties received from a related CFC. Whether used separately, or in conjunction with the AFE, this provision allows U.S. insurance groups to reduce some of the current tax costs associated with the Subpart F regime.

The availability of cross-border deferral under the AFE provisions, coupled with the pending introduction, in some jurisdictions, of the Solvency II regime, has led some insurance groups to consider operating their foreign insurance businesses in branch form. While the initial appeal of operating as a branch was a reduced cost/regulatory structure when compared with the legal entity form of doing business, the economic appeal is enhanced under the AFE rules for qualified cross-border business in combination with capital efficiencies that are possible under Solvency II.

Although organizations continue to create branch structures to realize the benefits discussed above, uncertainty surrounding the future of U.S. tax policy, and specifically the possible non-renewal of the AFE and look-through rule, have the potential to immediately negate many of these same benefits. For example, if the expiration of the AFE at the end of 2009, and again at the end of 2011, had become permanent, many existing structures could have immediately become tax inefficient.

Another consideration stemming from the tax and regulatory efficiencies achieved through a qualifying branch structure is capital repatriation. Corporate repatriation policies of U.S. insurers with international operations are often driven by regulatory capital constraints and residual U.S. tax cost considerations. To the extent that a foreign operation is sufficiently capitalized to write business at desired levels, distributions of previously taxed income (PTI) resulting from Subpart F inclusions can be common. In a well-capitalized foreign insurer, accumulation of excess capital (as that term is defined for purposes of the AFE rules) will generate additional Subpart F income; so many insurance groups prefer to distribute PTI balances to the extent allowable under local regulations.

A final area of consequence relating to the retroactive extensions discussed above is the accounting for income tax implications. Because the taxation of international insurance operations is complex, associated income tax accounting consequences generally require significant professional judgment and substantial documentation to support a company's

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positions. Recently, this area has experienced an increase in SEC comment letter activity, especially on the indefinite reversal criterion of Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 740, "Income Taxes" (formerly included in APB Opinion 23). Under ASC 740, deferred income taxes are not recognized on certain temporary differences related to earnings of foreign subsidiaries, unless it becomes apparent that those temporary differences will reverse in the foreseeable future.

The ASC 740 assertion of indefinite reinvestment of foreign earnings can be problematic for insurance groups subject to some level of tax on their foreign earnings. While the AFE regime may provide an element of deferral, income from insurance contracts that are not "exempt" contracts and excess capital can still produce current Subpart F inclusions. For these groups, repatriation decisions must be carefully made so that distributions of foreign earnings do not exceed existing balances of PTI as defined in section 959. Distributions in excess of PTI could jeopardize an assertion that either historic earnings and/or currently untaxed earnings are indefinitely reinvested and do not require deferred tax liabilities.

The ASC 740 assertion of indefinite reinvestment of foreign earnings can be problematic for insurance groups subject to some level of tax on their foreign earnings.

The extension of the AFE for insurance CFCs has created several accounting issues apart from the indefinite reversal criterion. When the AFE provision expired at the end of 2009, many practitioners felt it would be extended with retroactive effect before the end of the first quarterly financial statement period of 2010. When no extension was enacted by March 31, 2010, companies relying on it had to book larger financial statement tax provisions to account for the loss of deferral previously received under the AFE. Congress finally enacted a two-year extension on Dec. 17, 2010, providing for retroactive application of the AFE for 2010 and prospective application for 2011. Enactment of retroactive application of AFE for 2010 during 2010 allowed companies to reverse the previously recorded financial statement tax provision attributable to the expiration of the AFE in their 2010 financial statements. The most recent retroactive extension of the AFE on Jan. 2, 2013 has created a more complicated circumstance with respect to the application of ASC 740 guidance.

Companies should have previously factored in the lapse of the CFC look-through rule and the AFE in measuring 2012 current and deferred taxes on earnings of foreign subsidiaries. Because of the expiration of both provisions, U.S. companies may have been required to recognize 2012 current and deferred taxes related to certain earnings of foreign subsidiaries even if the subsidiary did not plan to remit earnings to the U.S. parent. As a result of the extension of these provisions, entities may need to adjust 2013 current and deferred taxes related to those earnings of foreign subsidiaries.

Under ASC 740, the effects of new legislation are recognized upon enactment, which in the United States is the date the president signs a tax bill into law. Although the provisions discussed herein are effective retroactively for 2012, companies may only consider currently enacted tax law as of the balance sheet date in determining current and deferred taxes. For calendar-year-end reporting companies, this means that both the retroactive tax effects for 2012 and the tax effects for 2013 will be recognized in the 2013 financial statements. During the first quarter of 2013 (the period that includes the enactment date) for calendar-year-end reporting entities, any amounts pertaining to the retroactive effects for 2012 and adjustments to deferred taxes as of the enactment date, would be recognized as a discrete item and would not be reflected in the 2013 estimated annual effective tax rate. Companies may therefore wish to consider additional 2012 financial statement disclosures in which they discuss the tax impact of the retroactive extensions.

In summary, the CFC look-through rule and the AFE will continue to have a substantive effect on the tax profile of U.S.-based groups with international insurance operations, both from a cash tax and U.S. GAAP perspective. As we look ahead, the broader question of international tax reform and its impact on these provisions remains unclear. The temporary two-year extension afforded by The Act, while a welcome development, does not address planning considerations absent a permanent extension. In fact, two significant reform proposals introduced in the previous Congress (the Camp International Reform Discussion Draft—Oct. 26, 2011 and the Enzi bill titled "The United States Job Creation and International Tax Reform Act of 2012"—Feb. 9, 2012) differ on the future of both provisions. Under the Camp proposal, both provisions would be permanently repealed; while under the Enzi proposal, both provisions would be permanently extended—stay tuned as this debate continues.

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END NOTES

[1] See Internal Revenue Code section 953(e)(3) for the definition of "qualifying insurance company" and Code section 953(e)(4) for the definition of "qualifying insurance company branch."

ACLI UPDATE DEFICIENCY RESERVE GUIDANCE

By Walter Welsh, Mandana Parsazad and Pete Bautz

On 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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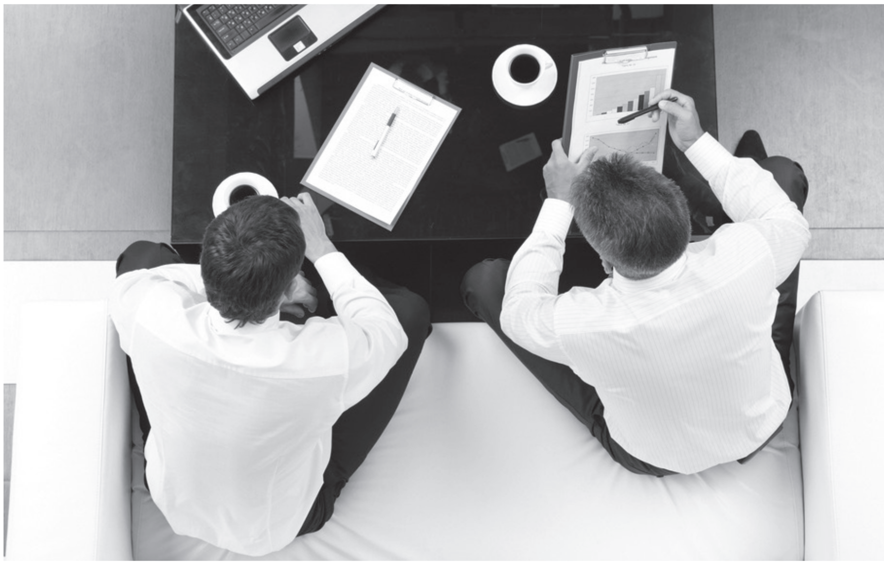

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Although these regulations are final, ACLI and its members are studying the rules to provide feedback to and seek clarification from Treasury and IRS on any areas where the rules are highly ambiguous or absolutely unworkable.

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.

T³: *TAXING TIMES* TIDBITS

2012–2013 PRIORITY GUIDANCE PLAN—WHAT'S IN IT FOR LIFE INSURANCE COMPANIES?

By Susan J. Hotine

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In mid-November 2012, the Internal Revenue Service (IRS) and Department of Treasury released the 2012–2013 Priority Guidance Plan, which sets forth some 317 projects as priorities for allocation of their resources during the 12-month period from July 2012 through June 2013. The section for Insurance Companies and Products contains 10 projects, nine of which would address life insurance issues (as opposed to property/casualty issues), seven of which are substantially the same as what was listed in last year's plan. The two new projects addressing life insurance issues are:

• Guidance to clarify which table to use for I.R.C. § 807(d)(2) purposes when there is more than one applicable table in the 2001 CSO mortality table; and

• Guidance clarifying whether the Conditional Tail Expectation (CTE) Amount computed under Actuarial Guideline (AG) 43 should be taken into account for purposes of the Reserve Ratio Test under I.R.C. § 816(a) and the Statutory Reserve Cap under I.R.C. § 807(d)(6).

The CTE Amount project was expected because these issues were specifically left open by Notice 2010-29[1] in providing guidance on how to implement AG 43 for tax purposes when it became effective at the end of 2009. However, the 2001 CSO mortality table project came as a surprise to the industry. Because it had not been something discussed at insurance tax conferences and had not been among the projects recommended by the industry through the American Council of Life Insurers (ACLI), it is difficult to infer what specific problem or issue the project will address. Informal feedback from the IRS Insurance Branch indicates that the 2001 CSO mortality table project was added to the Guidance Plan at the request of the IRS Field offices but, if the project is supposed to address some issue that is being identified in exams, it is not an issue about which companies generally are aware. Could what seems like a simple company tax issue have unintended consequences for life insurance products? For example, I.R.C. § 7702(c)(3)(B)(i) cross references the prevailing commissioners' standard tables defined in I.R.C. § 807(d)(5), which determines the applicable mortality table to be used for the I.R.C. § 807(d)(2) computation.[2] Thus, the 2001 CSO mortality table project could be somewhat of a wild card from the industry perspective. Hopefully the IRS Chief Counsel's office will bring the industry into the picture to discuss the issue being addressed and any tentative conclusions before reaching any final decision in order to avoid unforeseen and unintended adverse consequences the final guidance might have.

Specifically, the projects listed for Insurance Companies and Products are:

1. Final regulations under I.R.C. § 72 on the exchange of property for an annuity contract. Proposed regulations were published on Oct. 18, 2006. (This has been the same for the last several years.)

2. Guidance on annuity contracts with a long-term care insurance rider under I.R.C. §§ 72 and 7702B. (This was on the 2011–2012 Plan and the IRS published Notice 2011-68,[3] so there must be more coming.)

3. Revenue Ruling under I.R.C. § 801 addressing the application of Revenue Ruling 2005-40 or Revenue Ruling 92-93 to health insurance arrangements that are sponsored by a single employer. (This was on the 2011-2012 Plan.)

4. Guidance to clarify which table to use for I.R.C. § 807(d)(2) purposes when there is more than one applicable table in the 2001 CSO mortality table. (This is a new project; see discussion above.)

5. Notice clarifying whether deficiency reserves should be taken into account in computing statutory reserves under I.R.C. § 807(d)(6). (This project had been in past Guidance Plans, with the language changing from "Guidance" to a "Revenue Ruling" to a "Notice"; presumably this project was completed with the recent publication of Notice 2013-19.[4])

6. Revenue Ruling on the determination of the company's share and policyholder's share of the net investment income of a life insurance company under I.R.C. § 812. (This has been the same for the last several years, except a "Revenue Ruling" has been substituted for the more general term "Guidance" used earlier.)

7. Guidance clarifying whether the CTE Amount computed under AG 43 should be taken into account for purposes of the Reserve Ratio Test under I.R.C. § 816(a) and the Statutory Reserve Cap under I.R.C. § 807(d)(6). (This is a new project; see discussion above.)

8. Regulations under I.R.C. § 833 to establish the method to be used by Blue Cross Blue Shield entities in determining the medical loss ratio required by that section. (This is a new project and addresses an issue for health insurance companies from the Affordable Care Act of 2010.)

9. Guidance on exchanges under I.R.C. § 1035 of annuities for long-term care insurance contracts. (This was on the 2011–2012 Plan.)

10. Regulations under I.R.C. § 7702 defining cash surrender value. (This has been the same for the last several years.)

While the 2012–2013 Priority Guidance Plan includes the CTE Amount project, there is no project on principle-based reserves (PBR) for life insurance contracts as requested by the ACLI. However, even if the ACLI's request for a life PBR project may have been declined (*e.g.*, because the rules are not yet required for tax purposes), IRS Insurance Branch representatives have indicated that life PBR issues are still being actively considered.

Other projects included in the 2012–2013 Priority Guidance Plan that are not directed to, but may be of interest to, life insurance companies are:

- Financial Institutions and Products—Guidance addressing the character and timing of hedge gains and losses for purposes of I.R.C. § 1221 and Treas. Reg. § 1.446-4 for hedges of guaranteed living benefits and death benefits provided with regard to variable annuities. (This was on the 2011–2012 Plan.)

- General Tax Issues—Final regulations under I.R.C. § 7701 regarding Series LLCs and cell companies. Proposed regulations were published on Sept. 14, 2010. (This is a new project.)

- International Issues (Inbound Transactions)—Regulations under I.R.C. § 882 regarding insurance companies. (This is a new project.)

- Tax Accounting—Regulations under I.R.C. § 453 addressing certain annuity contracts received in exchange for property. (This has been on the Guidance Plans for the last several years.).

END NOTES

[1] 2010-15 I.R.B. 547.

[2] Apparently the 2001 CSO mortality table project is not intended to include a reconsideration of the analysis in PLR 201230009 (Jan. 30, 2012), which surprised the industry by concluding that a reduction in death benefit would cause a life insurance contract to be "newly issued" for purposes of the safe harbors provided in § 5 of Notice 2006-95, 2006-2 C.B. 848, for satisfying the reasonable mortality charge requirements of I.R.C. § 7702(c)(3)(B)(i).

[3] 2011-36 I.R.B. 205.

[4] 2013-14 I.R.B. 743.

APPLYING SECTION 72(S) TO JOINT-LIFE GLWBS COVERING NON-SPOUSES

By Alison R. Peak, Bryan W. Keene and Joseph F. McKeever

In January, the Internal Revenue Service ("IRS") released PLRs 201302015 and 201302016, which address how section 72(s) applies to a deferred annuity that has a guaranteed lifetime withdrawal benefit ("GLWB") rider covering the joint lives of the owner and a non-spouse beneficiary.[1] Section 72(s) requires certain distributions to be made from a non-qualified annuity after the owner dies.[2] If the beneficiary is the owner's surviving spouse, however, the contract can continue without section 72(s) requiring any distributions until the spouse dies.[3] In the two recent rulings, the contract issuer proposed a "New Distribution Option" that would allow a *non-spouse* beneficiary to continue the contract—and thus the GLWB coverage—after the owner's death, without requiring any distributions from the contract. The rulings conclude that this will comply with section 72(s). The key to the conclusion was that the New Distribution Option caused the contract's death benefit to be immediately taxable to the non-spouse beneficiary as if he had received it, even though

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no distribution would actually be made from the contract. Thus, the non-spouse beneficiary could continue the contract and its existing GLWB coverage, but not its prior tax deferral, following the owner's death.

FACTS

The contracts involved in the rulings are non-qualified, deferred variable annuities. If the owner dies before the annuity starting date, the named beneficiary can elect to receive a death benefit under one of three options that complies with section 72(s), *e.g.*, within five years of the owner's death. The contracts also include GLWB riders that operate in the typical fashion. For example, they guarantee a minimum withdrawal amount for the life of the owner or the joint lives of the owner and a beneficiary, but if withdrawals in excess of the guaranteed amount are taken, future guaranteed amounts are reduced or eliminated.

The rulings explain that section 72(s) can create an issue for a GLWB covering the joint lives of an owner and non-spouse beneficiary. If the owner predeceases the non-spouse beneficiary, a death benefit becomes payable under one of the contract's existing, section 72(s)-compliant distribution options, such as a full distribution within five years. Such distributions would likely exceed the guaranteed minimum withdrawal amount, thereby reducing or eliminating future GLWB coverage, even though the coverage was intended to continue for the joint lives of the owner and the non-spouse beneficiary. The New Distribution Option aims to address this problem.

Under the New Distribution Option, the contract and GLWB rider would continue after the owner's death with the non-spouse beneficiary as the new owner, but without any actual distributions being triggered by the owner's death. Thus, there would be no forced "excess withdrawal" that would reduce future GLWB coverage. However, the New Distribution Option would require the non-spouse beneficiary to include in his gross income the amount that would have been taxable to him had he instead elected to completely surrender the contract for its death benefit. In that regard, the beneficiary would be required to "affirmatively and irrevocably decline the existing distribution options" by signing an election form. The form would state that (1) the beneficiary will not actually receive a death benefit payment but will be treated as receiving one for tax purposes, and (2) the contract issuer will send the non-spouse beneficiary a Form 1099-R reporting the gross and taxable amounts of the death benefit that he will be treated as having received as a result of electing the New Distribution Option.

The discussion of applicable law and the analysis in the rulings are brief. They restate the applicable portion of the section 72(s) requirements and then observe that:

> Examination of the text and purpose of § 72(s) indicates an intent that the entire interest of non-qualified annuity contracts be distributed within certain periods following the death of the holder in order to prevent additional tax deferral. We see no indication that § 72(s) prevents the non-spouse beneficiary of a non-qualified annuity contract holder from electing to be treated for tax purposes as if he or she had received that entire interest.

The rulings then conclude that the New Distribution Option will satisfy the requirements of section 72(s).

OBSERVATIONS

The rulings present an approach to applying section 72(s) that is not reflected in any prior IRS rulings. Based on the premise that section 72(s) is meant to limit tax deferral beyond the contract owner's death, the IRS seems to reason that as long as the deferral ends within the required time frame, section 72(s) is satisfied irrespective of whether any amount is *actually* distributed from the contract.

In that regard, we note that a cash basis taxpayer is generally taxed only on amounts that she actually or constructively receives, so a mere election to include an amount in income—absent actual or constructive receipt of that amount—would be insufficient to make it taxable.[4] Because the New Distribution Option does not result in the *actual* receipt of the death benefit, it presumably must result in its *constructive* receipt. Although the rulings do not delve into why (or even whether) electing the New Distribution Option results in constructive receipt, one reason might be that the non-spouse beneficiary must "affirmatively and irrevocably decline the existing distribution options" in order to elect the New Distribution Option. Having declined the existing distribution options, there is nothing standing between the non-spouse beneficiary and the death benefit other than a simple request for the money.

In sum, the rulings present an interesting means of complying with section 72(s) in circumstances where neither the insured nor the beneficiary wants the contract to terminate by virtue of an actual distribution. This approach would seem to be particularly helpful in the context of GLWB riders covering the joint lives of two individuals who are not spouses, *e.g.*, siblings, couples who live together but choose not to marry, and same sex couples who may be partners to a civil union or enjoy status as spouses under state law but not federal law.[5]

END NOTES

1 The rulings were issued on July 13, 2012, and were released to the public on Jan. 11, 2013. The rulings appear to have been issued to affiliated life insurance companies.

2 Section 72(s) distributions are triggered by the death of any contract "holder," which generally means any owner. If an owner dies on or after the annuity starting date, any remaining interest in the contract must be distributed at least as rapidly as the method of distribution being used on the date of death. Section 72(s)(1)(A). If an owner dies before the annuity starting date, any remaining interest in the contract must be distributed within five years of the owner's death or over the life or life expectancy of a designated beneficiary starting within a year of the owner's death. Section 72(s)(1)(B) and (2).

3 Section 72(s)(3).

4 *See* Treas. Reg. section 1.451-1(a).

5 *See* Defense of Marriage Act, 1 U.S.C. § 7 (defining "spouse" for purposes of federal law as "a person of the opposite sex who is a husband or a wife").

APPLYING SECTION 1035 TO A POST-DEATH EXCHANGE OF A SECOND-TO-DIE LIFE CONTRACT

By Mark E. Griffin

In January, the Internal Revenue Service (IRS) released PLR 201304003, which addressed the application of section 1035 to the exchange of a survivorship, or "second-to-die," life insurance contract after the death of one of the insureds for a new life insurance contract covering only the life of the surviving insured.[1] Section 1035(a)(1) provides that no gain or loss will be recognized on the exchange of a "contract of life insurance" for another "contract of life insurance." In addition, the regulations state, in part, that section 1035 does not apply "if the policies exchanged do not relate to the same insured."[2] As explained below, the IRS in PLR 201304003 concluded that the exchange satisfied this "same insured" requirement in the regulations and qualified for nonrecognition treatment under section 1035.

FACTS

A husband and wife (A and B) purchased a second-to-die life insurance contract (Old Policy), which provided for the payment of a death benefit equal to a specified amount ($X) upon the death of whichever spouse was the last to die. Old Policy was a life insurance contract under sections 1035(b)(3) and 7702. The couple transferred the contract to an irrevocable trust that they established (Old Trust).

One spouse (A) later died, leaving the surviving spouse (B) as the sole insured under Old Policy. B subsequently transferred Old Policy to a new irrevocable trust (New Trust) settled by B, with the consent of all the beneficiaries of Old Trust, in accordance with the requirements of state law. New Trust was the owner and sole beneficiary of Old Policy.

The trustee of New Trust exchanged Old Policy for a new life insurance contract (New Policy) under which New Trust was the owner and sole beneficiary, B was the sole insured, and the death benefit was equal to $Y. New Policy was a life insurance contract under sections 1035(b)(3) and 7702. The exchange was accomplished by New Trust assigning its interest in Old Policy to the issuer of New Policy, the new issuer issuing New Policy to New Trust, and the new issuer then surrendering Old Policy.

ANALYSIS AND CONCLUSION

In applying section 1035 to the exchange of Old Policy for New Policy, the IRS in PLR 201304003 considered (1) whether Old Policy and New Policy were life insurance contracts to which section 1035 applied, and (2) whether the exchange was one which qualified for nonrecognition treatment under that section.

- The IRS indicated generally that in order for Old Policy and New Policy to be contracts subject to section 1035, they must satisfy both section 7702 (which defines a "life insurance contract" for purposes of the Internal Revenue Code) and section 1035(b)(3) (which defines a "contract of life insurance" for purposes of section 1035).[3] Based on representations made by New Trust, the IRS was comfortable that Old Policy and New Policy satisfied these sections.

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• In determining whether the exchange qualified for nonrecognition treatment under section 1035, the IRS looked primarily to the same insured requirement in the regulations under section 1035. Notwithstanding that spouses A and B originally were the insureds under Old Policy, the IRS focused on the fact that at the time of the exchange, surviving spouse B was the sole remaining insured under Old Policy and the sole insured under New Policy. Based on this fact, the IRS determined that the same insured requirement in the regulations was satisfied in this case.

Accordingly, the IRS ruled that the exchange of Old Policy for New Policy qualified for tax-free treatment under section 1035, so that New Trust did not recognize any gain or loss on the exchange.

OBSERVATIONS

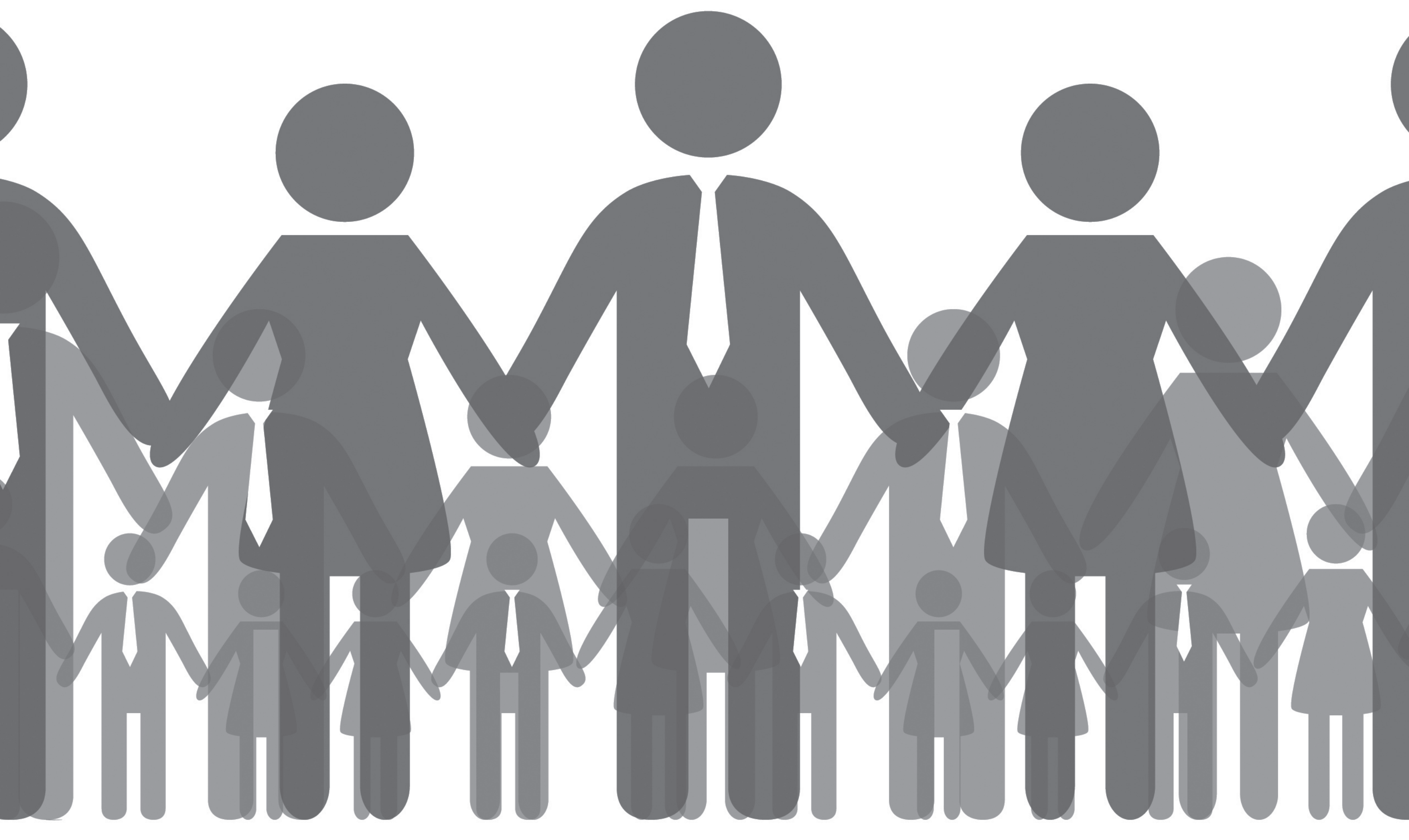
The facts and the IRS' reasoning in PLR 201304003 are similar to those in earlier private letter rulings. In particular, the IRS also determined in PLR 9330040 and PLR 9248013 that nonrecognition treatment under section 1035 applied to the exchange of a second-to-die life insurance contract after the death of one of the insureds for a new life insurance contract covering only the life of the surviving insured. It is noteworthy that all three of these private letter rulings include a caveat that the IRS expressed no opinion on whether section 1035 applies to the exchange of a second-to-die life insurance contract prior to the death of either of the insureds for a life insurance contract insuring a single life. However, the IRS in PLR 9542037 expressed the view that the same insured requirement was not satisfied, and thus that section 1035 nonrecognition treatment did not apply, in several situations involving exchanges of one or more single life insurance contracts for second-to-die life insurance contracts. Based on this view, it would seem unlikely that IRS would apply nonrecognition treatment under section 1035 to the exchange of a second-to-die policy while both insureds are alive for a life insurance contract covering only one life. ◂

END NOTES

[1] The private letter ruling was issued on Oct. 15, 2012, and was released to the public on Jan. 14, 2013.

[2] Treas. Reg. section 1.1035-1(c).

[3] A "contract of life insurance" is defined in section 1035(b)(3) generally as a contract with a life insurance company that depends in part on the life expectancy of the insured, but that is not ordinarily payable in full during the life of the insured. In addition, section 7702(a) sets forth the definition of a "life insurance contract" for purposes of the Internal Revenue Code.



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