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From the Chair

By Jeffrey Stabach

It is hard to believe that my term as chair has begun. It seems like I just started as a member of the council not long ago. The time has passed so quickly because I've been fortunate to work with such a dedicated group of people who are interested in educating others on tax matters. Time flies when you're having fun. I would like to thank our outgoing chair, Tim Branch, for his outstanding leadership over the past year. I'm very fortunate that Tim is only a few steps away from my office, and I'll be sure to keep engaging him in discussion on the section. Thank you, Tim! I'd also like to thank our outgoing council members: Tim, Kristin Norberg and Jim Van Etten for their service and hard work over the past three years.

I would also like to welcome our newly elected council members: Housseine Essaheb, Michele Cramer and Jeff Harper. It is great to see new faces becoming involved in the section, and I look forward to working with you all. Our council members have already been hard at work, with Don Walker accepting the role of vice chair and Housseine stepping in as our secretary and treasurer.

My mission for the upcoming year is to help better educate section members on tax matters. To accomplish this, we plan to continue sponsoring taxation sessions and boot camps at actuarial meetings, publishing *TAXING TIMES* and related podcasts, and developing webinars on emerging tax issues. We also plan to expand the scope of our activity with the following initiatives:

1. Regulatory Change Task Force Proposal—With regulatory change and potential tax reform on the horizon, we would like to keep our members better informed on the tax implications of these changes. With the help of the Society of Actuaries (SOA), we will be participating in creating a Web resource related to these changes. The Taxation Section page of the SOA website will serve as the first stop (not necessarily the last) for staying up-to-date on regulatory changes related to tax.



2. Exam tax content review—The exam process provides an educational foundation for all actuarial students. We will be reviewing the current exam syllabus for tax content to ensure that actuarial students are getting the appropriate tax knowledge to start their actuarial careers.

3. Outreach to other sections—To educate a broader audience, we will be partnering with other sections to explore the tax impacts of various topics at upcoming seminars and through co-sponsored articles.

In view of this ambitious agenda, we would be happy to have additional volunteers to help make these initiatives a success. Please feel free to reach out to me personally if you'd like to participate in any of these initiatives. ■

Note: The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

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Meet Alexis MacIvor, New Chief of the Insurance Branch

By Mark S. Smith

In February 2015, the Internal Revenue Service (IRS) Chief Counsel appointed Alexis MacIvor as the chief of Branch 4 of the Office of the Associate Chief Counsel (Financial Institutions & Products). That branch (sometimes referred to by our readers as the “Insurance Branch”) has seven attorneys who work exclusively on issues concerning the taxation of insurance companies and the products those companies issue. Because of the importance of that branch’s work product to the issues that life actuaries must address every day, the TAXING TIMES Editorial Board and the Taxation Section Council thought our readers would appreciate the opportunity to meet Alexis and welcome her to the insurance tax actuarial community.¹ Mark Smith of our editorial board recently met with Ms. MacIvor to talk about her background and her new role.

Smith: Alexis, thank you so much for taking the time to talk with us today. I know the first year in this position can be very hectic. Perhaps we could start by talking a little bit about your background. Did you always aspire to be a tax attorney?

MacIvor: When I went to college, I thought I wanted to be a scientist. Once at college, I figured out that I liked the analysis part, interpreting experimental results and comparing them to other scientific studies, but I did not like the field and lab work. I ultimately majored in environmental biology, a degree that included science and also added economics, sociology and other interdisciplinary courses. In exploring other fields that had similar analysis, I discovered law, and went to the University of Washington Law School.

While I was in my first year at law school, someone recommended that I take tax courses. So, I took a basic tax course. My professor, Sam Donaldson, was incredible. He would assign an Internal Revenue Code (Code) section or two for each class and spend a lot of time teaching the class how to read those sections. I found myself spending hours trying to figure out how the different Code provisions fit together. The Code was a puzzle, and I enjoyed trying to figure out how the pieces came together and which pieces were missing. I enjoyed tax so much that I decided to go to the University of Florida to receive an LLM in taxation.



Smith: So how did you end up specializing in insurance?

MacIvor: Before I joined the Insurance Branch, I was at Steptoe & Johnson LLP for about 9 years. At Steptoe, my practice included tax planning but focused on tax controversy and litigation. I spent significant time preparing for litigation and for conferences with Appeals. Some of this involved insurance issues for insurance companies and for non-insurance companies.

One of the things I enjoyed most about my practice was learning about a client’s business. Once I understood it, I could chart a legal course taking into account the client’s normal business operations and needs.

Drawing from these experiences, I took a step further and started teaching a course as an adjunct professor at the Georgetown LLM program that covers real estate investment trusts (REITs), regulated investment companies (RICs) and real estate mortgage investment conduits (REMICs); and also life insurance companies, property and casualty (P&C) companies, products and captives.

Smith: I understand you’ve been in the Insurance Branch for some time and have worked with many practitioners in your role with the government, as well as in the private sector. What has that been like, and how has it prepared you for this new challenge?

MacIvor: In the Insurance Branch I have worked on a variety of projects across the branch’s jurisdiction, including life insurance, non-life insurance and product taxes. I prepared private letter rulings (PLRs) and change in method of accounting letter rulings, and provided support to litigation attorneys. I also provided legal advice to Exam, Appeals, and the Issue Practice Groups (IPGs).

I worked with attorneys within the Insurance Branch, other branches in Financial Institutions & Products, and elsewhere in the Office of Chief Counsel, including other Associate Chief

Counsel offices and Division counsel on the examination side. The Chief Counsel's office has a wealth of specialized knowledge.

Smith: Could you elaborate on this a little bit? What are some of the circumstances where the branch works with other divisions in the Office of Chief Counsel? And, can you talk a little bit about some of the ways the branch works with the Large Business and International (LB&I) division?

MacIvor: The Office of Chief Counsel includes the operational side, such as LB&I and Small Business/Self-Employed (SBSE), and the technical side. On the technical side, the groups are divided by subject matter expertise. If the Insurance Branch is issuing a PLR regarding an insurance issue that also involves a provision within the jurisdiction of the Associate Chief Counsel International, we would work with those attorneys. Similarly, if attorneys in the Associate Chief Counsel Corporate are working on a PLR involving Subchapter L provisions, they would reach out to us for assistance. We also work with other attorneys within Financial Institutions & Products on financial products issues.

In addition to working with other attorneys on the technical side, we also work with attorneys on the operational side, including LB&I, and with agents. This assistance can result in Chief Counsel Advice (CCA), which is published. We also issue Technical Advice Memoranda (TAMs), which require the cooperation of the taxpayer and exam to submit a technical issue to us. TAMs may require assistance from attorneys in other divisions of Chief Counsel with subject matter expertise.

Smith: How would you describe the work environment in the branch itself, and how do you view your new role?

MacIvor: The Insurance Branch has strong attorneys who work very hard to get to the right answer. I have enjoyed learning from them since I started at the IRS, and I am excited to have this opportunity to lead them.

I also enjoy the camaraderie we have developed in the Insurance Branch. I have a tremendous amount of respect for the attorneys and am honored to be their branch chief. The attorneys collectively have a great depth of experience, and we work well together on projects. As the new branch chief, I want to encourage our attorneys to continue to expand the range of their experience and knowledge.

Smith: How does an attorney in government gain an understanding of the business of a taxpayer, and how important is that to figuring out how a particular issue should be treated?

MacIvor: I come from a private practice background and understand that business needs are key to companies. In my prior position, I could ask the client about its business. In my current

position, it is more difficult to achieve the same level of understanding about business practices and needs, and therefore more difficult to determine whether a technical response can accommodate those needs. In order to find creative solutions that best serve everyone, the Insurance Branch needs the industry to share information and educate us about current business practices. The industry changes and products change, sometimes rapidly. We learn about these changes from publications and from people telling us about them. The more we know, the better we are able to provide consistent guidance across the insurance tax community. I would encourage your readers to reach out and talk to me and to attorneys in the Insurance Branch so we understand your evolving business.

Smith: Funny you should mention the evolving business of insurance taxation. One of the most important developments in company taxation will be the adoption of a principle-based approach to life insurance reserves. There has been a long and productive dialogue between the branch and life insurers around tax

In order to find creative solutions that best serve everyone, the Insurance Branch needs the industry to share information and educate us about current business practices.

issues that will arise as a result of that adoption. Can you share with our readers your thoughts on the work that has been done to date on Life PBR?

MacIvor: As a new branch chief, I am getting up to speed on all of the work the Insurance Branch has done on various issues, including Life PBR. We are currently thinking about principle-based reserves and plan to coordinate closely with Treasury Office of Tax Policy on this issue. I look forward to continuing the productive dialogue between the branch and life insurers around Life PBR.

Smith: You've talked about the importance of the insurance tax community being open to the government and sharing information about the evolving issues that companies face. Likewise, the industry is always eager to learn about what's hot from the branch's perspective and what is the current thinking around particular issues. Your predecessor was very generous with her time and opinions on a variety of issues. Do you have thoughts on continuing that openness?

MacIvor: I fully support this open dialogue to the extent it is permitted. Since joining the branch, I have spoken on panels at the Federal Bar Insurance Tax Seminars and the Society of Actuaries Product Tax Seminar. I anticipate that the Insurance Branch will continue to participate in similar conferences. These conferences are an opportunity for the industry to ask questions and hear directly from attorneys in the Insurance Branch. Many times we are able to clarify the scope of recently published guidance, PLRs, TAMs and CCAs.

While we want to have a productive dialogue with the industry, we are limited on what information we can share. For example, we cannot discuss a matter pending before another office of the IRS or before a court, and Code section 6103 prohibits us from sharing taxpayer and return information.

Smith: One question I hear often in practice is how long a particular work product, such as a PLR, might take once it is submitted. Do you have any suggestions how one might tee up issues for the branch in a way that they can be processed efficiently from your own perspective?

MacIvor: Well, for one thing I encourage pre-submission conferences. For the Insurance Branch, a submission is much easier to process if we have an opportunity to discuss with the taxpayer the information we need. In addition, we have an opportunity to explain potential problems and lay out coordination that may be required. If the subject matter is not under our jurisdiction, we may need to coordinate with another office within Chief Counsel.

Smith: What about life insurance products? I know there has historically been anxiety around guidance in the product area because of a fear that changes in the IRS' ruling position will create a hardship for products that already have been issued. Do you have any thoughts on this?

MacIvor: I understand that changes to the tax rules may impact the taxation of those products and their pricing. I also appreciate that companies cannot retroactively change the price of products. That being said, seeking a PLR is a good way to obtain some certainty. A taxpayer may ordinarily rely on a PLR it receives, and if there is a subsequent change in ruling position or guidance, the change ordinarily is applied prospectively. But I also think this issue goes back to making sure we have a productive dialogue with the industry. If we know that the industry has

taken a certain position, or that companies are taking different positions, we can be sensitive to these issues.

Smith: That's interesting. On the products side, many of the existing rules (such as the definition of life insurance contract) were new in 1984. But as to Company side, some issues have a very much longer history. How does one approach that?

MacIvor: The majority of Subchapter L was enacted in 1984. These provisions have significant similarities and also clear deviations from prior insurance provisions. This historical background in conjunction with major changes in the industry results in some of our most significant challenges. In the Insurance Branch, we have attorneys with a lot of historical and institutional knowledge. We rely on them to help us understand this history and to determine whether it influences our interpretation of those provisions.

Smith: Is there anything else you would like to share with us today?

MacIvor: I appreciate this opportunity to tell you a little about myself. I encourage members to reach out and introduce themselves to me and the other attorneys in the Insurance Branch. We are interested in having a dialogue with the industry and hearing about the industry's priorities and issues. ■

The content of this article is the opinion of the writer and does not necessarily represent the position of the Internal Revenue Service.

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END NOTES

¹ *TAXING TIMES* previously interviewed William J. Wilkins, IRS Chief Counsel, 1 *TAXING TIMES*, Vol. 6, Issue 1 (February 2010); Helen Hubbard, Associate Chief Counsel (FI&P), 1 *TAXING TIMES*, Vol. 10, Issue 2 (May 2014);

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

How Are Nonqualified Annuities Taxed?

By John T. Adney

The federal income tax law includes within its ambit “all income from whatever source derived,”¹ so it should be no surprise that payments insurers make from annuity contracts are subjected to it. What may be surprising, however, are the myriad rules in the Internal Revenue Code that govern how the federal government collects, and in some instances does not collect, that tax. This column endeavors to outline those rules as they apply to “nonqualified” annuity contracts issued by licensed insurance companies. A nonqualified annuity is one issued apart from an employer pension plan or individual retirement account (IRA) or other tax-qualified retirement arrangement. A description of the rules bearing on “qualified” annuities as well as arrangements known as “private annuities” (which do not involve insurers) will not be covered here since discussing the tax treatment of insurer-issued nonqualified annuities will involve enough of a journey for the reader.

Before launching into a description of the way federal law taxes (or refrains from taxing) the values of annuity contracts, it is necessary to understand what is meant by the term “annuity.” The concept of an annuity is quite old, dating back to the Babylonian Empire of antiquity and possibly to the Chinese before then, and generally connotes an arrangement whereby one party, in return for a sum of money, agrees to make payments periodically to another party throughout the latter’s life or for a specified term of years. Building on that principle, the modern insurer-issued annuity contract comes in a number of forms, most notably the deferred annuity and the immediate annuity. The deferred annuity, which may be purchased with a single consideration or multiple premium payments, contains the promise of periodic payments but defers for some time (and sometimes for quite a long time) the beginning of the payment stream. When the payment stream commences, the contract is said to be “annuitized.” On the other hand, the immediate annuity, as its name suggests, is purchased with a single premium and begins making payments within one month to one year after its purchase. In either case, the periodic payments (aka annuity payments) may be made over the life or lives of a named annuitant or joint annuitants, for a

specified term of years (known as a term certain), or for life with a minimum term or amount of payments.

Beyond these principal forms of annuities, many variations exist. For example, an annuity may be “fixed,” meaning its values are guaranteed by the issuing insurer’s general account, or “variable,” meaning that its values can fluctuate with the market value of assets held in a separate account of the insurer. The modern deferred annuity usually offers cash surrender values, often subject to a surrender charge in a contract’s early durations, and the modern immediate annuity or the deferred annuity that has been annuitized may or may not provide surrender or commuted values. Deferred annuities with cash values include the indexed annuity, which promises a return based on a market-based index if the contract continues to the end of a stated term, and the “modified” guaranteed annuity, which offers greater interest earnings over a stated term subject to a market value adjustment if the contract is surrendered before the term expires. On the other hand, in recent times an older form of deferred annuity has again become popular. Known as the deferred income annuity or longevity insurance, this form simply begins making payments at a stated age of the annuitant and offers no surrender value other than possibly a return of premium on premature death. A variant of this is sometimes called the contingent deferred annuity, which coordinates its promised payments with the depletion of a specified fund external to the contract. Somewhat similarly, the variable deferred annuity may come with guaranteed minimum withdrawal benefits (GMWBs), constituting a promise—without initially annuitizing the contract—to permit continued withdrawals for a specified term or over the life of the contract owner even after the contract’s cash value has been reduced to zero, so long as the withdrawals have not exceeded a stated maximum. There is also a so-called temporary life annuity, with payments being made over the shorter of a specified term and the annuitant’s life.

Tax definition of “annuity.” The federal tax law endeavors to address all of these annuity forms, subject to its own definition of an annuity. The tax law’s definition of an annuity is found partly in the Code, partly in the income tax regulations, and partly in case law (i.e., decisions by the courts). The regulations under section 72—the principal provision of the Code governing annuity taxation—largely define an annuity contract by drawing on insurance tradition. They provide that annuity contracts subject to the section 72 rules “include” those considered to be “annuity contracts in accordance with the customary practice of life insurance companies.”² Thus, the treatment of a contract as an annuity under state law, which is the law governing insurer-issued annuities, would appear to be an important element in the tax definition. Further, according to the courts, to constitute an annuity contract under the tax law the contract must provide for periodic payments that will liquidate the premiums and any

earnings on those premiums.³ This liquidation requirement, together with the reference to life insurers' customary practice, suggests that a deferred annuity contract should provide for a stated date on which annuity payments are to begin at some reasonable maximum age of the annuitant,⁴ although there is little guidance and some debate on this point. The Code does, however, place a specific limit on the lifespan of an annuity contract, whether deferred or in payout mode, by requiring the liquidation of the contract when its owner (technically, the contract's "holder") or any one of multiple owners dies. Specifically, and importantly if the contract is to be treated as an annuity for tax purposes, section 72(s)⁵ requires the contract to provide by its terms that:

- If any owner dies on or after the "annuity starting date," which is more or less when the payment stream begins, any remaining payments will be made at least as rapidly as they had been before death (i.e., the payments cannot be slowed down), and
- If any owner dies before then, the entire interest in the contract will be distributed within five years of death.

The statute allows two exceptions. First, an individual who is a designated death beneficiary may elect payments over his or her life (or a period not exceeding life expectancy) if the first payment is made within one year of death.⁶ Second, if that beneficiary is the deceased owner's spouse, he or she may continue the contract as the new owner, assuming the contract so permits.

So, can the section 72(s) limitations be avoided by having an annuity held by a trust? After all, many deferred annuities are so held. Congress thought of that, specifying in section 72(s) that where an owner is not an individual, the statute's rules apply as if the "primary annuitant" were the owner, and if the annuitant is changed, the change is treated as the owner's death.⁷ Fine, but what about simply gifting the annuity when the individual owner is on his or her deathbed? Congress thought of that, too. Pursuant to section 72(e)(4)(C), the complete gift of an annuity generally is treated as a surrender, subject to the tax consequences described below unless the donee is the transferor's spouse or former spouse.

Inside buildup. The good news for the annuity contract owner, if the contract meets the tax definition just described, is that any increments in the contract's cash surrender value generally are not taxable until they are distributed. This is true even though amounts of cash values allocated to or among investment options under a variable or indexed annuity are reallocated among such options. This treatment is often referred to as the "inside buildup" tax deferral. There is no provision in the Code that expressly provides this treatment, but the courts and the Internal Revenue Service (IRS) have agreed that this treatment exists, based on the structure of section 72 as well as the tax law's doctrine of



constructive receipt. Congress has examined the treatment of the inside buildup from time to time and has sustained it as an important part of national retirement policy, although Congress also has taken steps to limit it, such as by enactment of the section 72(s) rules and also by denying this treatment to contracts that benefit corporations and other non-individuals. The latter restriction shows up in section 72(u), which taxes the income on such contracts to their owners as ordinary income in the year it arises, although a number of exceptions to this are available under the statute, most notably for immediate annuities and for a trust or other entity that owns the contract as an agent for a natural person. Since many annuities are trust-owned, this exception has been the object of much attention by the IRS and tax practitioners, who at times find its application less than crystal clear.⁸ Still another limitation exists on a contract owner's ability to benefit from inside buildup tax deferral, applicable in the case of a variable contract. In such a case, the separate account investments funding the variable benefits must be "adequately diversified" pursuant to regulations under section 817(h), and the contract owner must not be viewed as controlling the underlying investments—the so-called investor control doctrine.⁹

Taxing annuity benefits. As just noted, when an annuity contract pays benefits, the payments become subject to federal income tax, either in whole or in part. Determining the extent of the taxation is the work of section 72, and what it requires depends on the nature of the payment:

- *Lump-sum surrenders and death benefits.* If a contract is fully surrendered for a lump-sum payment, the proceeds are taxable to the owner at ordinary income tax rates to the extent they exceed the investment in the contract. Also, the lump-sum payment of death benefits is taxed to the beneficiary in the same way; there is no annuity death benefit exclusion as there is for life insurance death benefits. In this context,

the phrase “investment in the contract” (sometimes called tax basis) means the premiums paid for the contract less any amounts previously received under it that were excludable from income. These rules appear in section 72(e).

- *Partial surrenders or withdrawals, including loans.* The amount of a partial surrender or withdrawal taken from an annuity contract before annuity payments begin, which the Code calls an “amount not received as an annuity,” is taxable under section 72(e) at ordinary income tax rates to the extent the contract’s cash value immediately before the withdrawal, unreduced by any surrender charges, exceeds the investment in the contract at that time (using the definition above). This creates an income-first or “LIFO” rule, which sounds simple enough but is complicated by some uncertainty on what a “cash value” is; the IRS and the Treasury Department are just now considering issuing guidance on this, even though the rule has been in the law for over three decades.¹⁰ This rule applies to GMWBs to the extent they cannot qualify as annuity payments (see below). Also, if an amount is borrowed under or against an annuity contract, the borrowing is treated as a partial withdrawal, as is an assignment or pledge of the contract. Further, to prevent avoidance of the income-first rule through the purchase of a series of contracts, section 72(e) (12) “aggregates” all annuity contracts issued by the same insurer (or its affiliates) to the same owner during the same calendar year, i.e., they are treated as a single contract in measuring the income element of the withdrawal.¹¹
- *Annuity payments.* The periodic payments made under an immediate annuity, or under a deferred annuity that has been annuitized, are referred to as “amounts received as an annuity.” The treatment of these amounts under section 72(b) is a beneficial one, in that the investment in the contract is allowed to be recovered (untaxed) ratably with each payment, so that each payment is partly includible in and partly excludable from income. To qualify for this “exclusion ratio” treatment, the payments must pass three tests: (1) they must be made on or after the annuity starting date; (2) they must be made in periodic installments at regular intervals for more than one year; and (3) either the amount to be paid must be determinable when the payments begin or else the period over which the payments will be made must be determinable then but the amount of each payment may vary based on investment performance or “similar fluctuating criteria.”¹² Despite the term “withdrawals” in their name, some GMWBs may qualify for exclusion ratio treatment, depending on their structure.

Annuity payments may be fixed or variable; the last of the three tests permits either (or a combination). In the case of fixed annuity payments, the excludable portion—i.e., the untaxed investment recovery—generally is the amount of the

Every silver lining has a cloud, and the one that hovers over the beneficial treatment of the inside buildup of annuities is the section 72(q) penalty tax.

payment multiplied by the exclusion ratio, which in turn is computed as the investment in the contract on the annuity starting date, adjusted for any refund feature, divided by the expected return under the contract as of that date. See the sidebar for an illustration of this calculation that appears in the section 72 regulations. For variable annuity payments, this is done a little differently: the excludable portion of a payment equals the investment in the contract allocated to the variable account, again adjusted for any refund feature, divided by the number of payments expected. This results in a fixed excludable amount for each payment.¹³ In neither case, however, will section 72(b) allow the taxpayer to recover more than the investment in the contract tax-free.¹⁴

The regulations under section 72 spell out the rules for these calculations, including the three tests, in great detail.¹⁵ However, the reader should be aware of the fact that the regulations, mostly dating from 1956, have not been updated to reflect many of the statutory changes made to section 72 in the 1980s and even as recently as 2010. In 2010, an amendment to section 72 clarified that a contract could be partially annuitized. To enable this, section 72(a)(2) treats the portion of the contract being annuitized as a separate contract, provides it with its own annuity starting date, and directs a pro rata allocation of the investment in the contract between the annuitized portion and the non-annuitized balance.

- *Penalty tax.* Every silver lining has a cloud, and the one that hovers over the beneficial treatment of the inside buildup of annuities is the section 72(q) penalty tax. To encourage the use of deferred annuities for retirement savings and discourage their potential use as short-term savings vehicles, Congress imposed a penalty tax equal to 10 percent of the income portion of annuity contract distributions that are considered premature. The exceptions to this additional tax are therefore important. Somewhat mirroring the rules for tax-qualified retirement plans, the penalty tax is not imposed on distributions when the taxpayer is over age 59-1/2 or disabled, payments from immediate annuities (as specially defined for tax purposes), death benefits, and substantially equal periodic payments made for life or over life expectancy, among others.

Example: Exclusion ratio for fixed annuity payments. Taxpayer A purchased an annuity contract providing for payments of \$100 per month for a consideration of \$12,650. Assuming that the expected return under this contract is \$16,000, the exclusion ratio to be used by A is $\$12,650 \div 16,000$, or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount that A may exclude from gross income in such year is \$949.20 ($\$1,200 \times 79.1$ percent). The balance of \$250.80 ($\$1,200$ less \$949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, A should exclude \$395.50 (500×79.1 percent) of the total amounts received.¹⁶

- *Net investment income tax.* Distributions from annuity contracts do not escape the “net investment income tax” imposed by the 2010 health care legislation. The tax under section 1411 applies at a 3.8 percent rate on net investment income, subject to certain threshold amounts. Fortunately, only the portion of an annuity distribution that is taxable is considered net investment income, meaning in turn that the inside buildup is (again) not taxed unless and until amounts are distributed. The application of this tax to annuity contract payments was discussed at length in prior *TAXING TIMES* articles.¹⁷

Exchanges, full and partial. Another beneficial tax treatment accorded to annuities, among other insurance instruments, is that they may be exchanged tax-free for a new annuity contract or for a qualified long-term care insurance contract under section 1035. This treatment has been construed to extend to the exchange of one annuity contract for two, an exchange that consolidated one annuity into another existing one, the exchange of a fixed annuity for a variable one, and very importantly, the “partial exchange” of a contract, whereby a portion of the contract is transferred into a new or existing annuity. On the other hand, the IRS takes the position that a section 1035 exchange must be in-kind, not in cash, and any cash received in the course of the exchange is taxable as “boot,” basically following an income-first rule. The IRS has published guidance on the conditions under which a partial exchange will be treated as tax-free.¹⁸

Concluding thoughts. The author’s hope is that the reader of this column will gain some insight into the federal income tax treatment of nonqualified annuity contracts. The foregoing is far from a comprehensive treatise on annuity taxation. It generalizes many points and slides over some subtleties, and does not at all touch the taxation of annuities by the states (a few even impose

a premium tax at annuitization). Annuity taxation is a complex subject with a rich history, but on reaching this point the reader will have made a start on the road to understanding it. ■

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END NOTES

- ¹ I.R.C. § 61(a). Unless otherwise indicated, references to “section” are to sections of the Internal Revenue Code of 1986, as amended (the Code).
- ² Treas. Reg. § 1.72-2(a)(1). The regulations go on to say that section 72 can apply to annuities not issued by insurers.
- ³ See *Igleheart v. Comm’r*, 10 T.C. 766 (1948), *aff’d*, 174 F.2d 605 (7th Cir. 1949).
- ⁴ See *Northern Trust Co. v. United States*, 389 F.2d 731, 733 (7th Cir. 1968); GCM 38934 (July 9, 1982).
- ⁵ Applicable to contracts issued after Jan. 18, 1985.
- ⁶ A discussion of a recent IRS private letter ruling discussing this rule appears in this issue of *TAXING TIMES*. See Mark E. Griffin and Alison R. Peak, “IRS Applies Strict Reading of Section 72(s),” page 45.
- ⁷ The section 72(s) rules do not apply to contracts used in qualified retirement plans or section 130 structured settlements. I.R.C. § 72(s)(5)(A)–(D).
- ⁸ Current taxation of the inside buildup also applies, under the Code’s “original issue discount” rules, in the case of a deferred annuity contract issued by an insurer (other than a tax-exempt insurer) not subject to tax by the United States with respect to the contract. Treas. Reg. § 1.1275-1(k). This rule typically affects foreign-issued deferred annuities.
- ⁹ This doctrine encompasses an expansive and somewhat slippery subject. If the reader is so inclined, he or she may want to see the 92-page opinion of the U.S. Tax Court in a case called *Webber v. Commissioner*, 144 T.C. No. 17 (2015), which describes how not to arrange one’s affairs to reduce taxation. An article on *Webber* also appears in this issue of *TAXING TIMES*. See Ann Cammack and Frederic J. Gelfon, “Investor Control: Will You Know it When You See it?” page 36.
- ¹⁰ The income-first rule, enacted in 1982, does not apply to amounts allocable to investment before Aug. 14, 1982. See Revenue Ruling 85-159, 1985-2 C.B. 29.
- ¹¹ Applicable to contracts issued on or after Oct. 21, 1988.
- ¹² Treas. Reg. § 1.72-2(b)(2)–(3).
- ¹³ See Treas. Reg. §§ 1.72-2(b)(3), 1.72-4(d)(3).
- ¹⁴ A deduction is available under section 72(b) for any unrecovered investment in the contract when payments cease (such as by the annuitant’s death).
- ¹⁵ See the regulations under section 72 for these details, examples of the calculations, and the actuarial tables to be used. The regulations appear at Treas. Reg. § 1.72-1 through 18.
- ¹⁶ Per Treas. Reg. § 1.72-4(a)(2).
- ¹⁷ John T. Adney and Alison R. Peak, “Proposed Guidance on the New Net Investment Income Tax on ‘Annuities,’” *TAXING TIMES*, May 2013, Vol. 9, No. 2; John T. Adney and Alison R. Peak, “Tapping a New Revenue Source—Congress Expands the Medicare Tax Base to Include Income from ‘Annuities,’” *TAXING TIMES*, September 2010, Vol. 6, No. 3.
- ¹⁸ See Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (superseding and modifying Rev. Proc. 2008-24, 2008-13 I.R.B. 684).



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

By Peter H. Winslow (Moderator), John T. Adney, Sheryl Flum,¹ Susan Hotine and Mark Smith

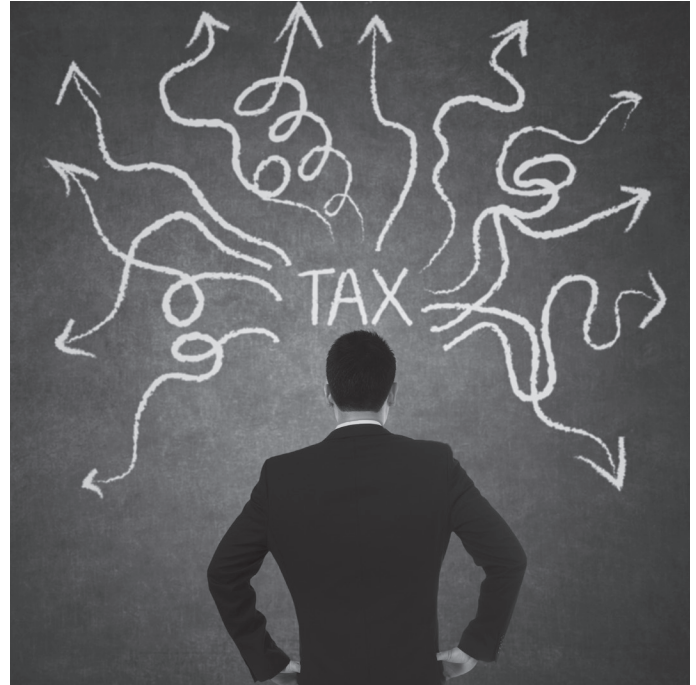
Note from the Editor:

Welcome again to our series of dialogues on the important and evolving topic of the extent to which federal tax law defers to the National Association of Insurance Commissioners (NAIC) in taxing life insurance companies and products. In the prior two issues of TAXING TIMES, our distinguished panelists explored many aspects of tax reserves including their deductibility, classification and computation,² as well as product tax considerations relating to life insurance, annuities, long-term care insurance and accelerated death benefits.³ In this Part III, the panelists will address legal and accounting questions relating to insurance classification and qualification under U.S. federal income tax law: examining the various characteristics required for a company to be treated as a life insurance company, for a transaction to be treated as insurance, for a reinsurance arrangement to be respected as such, and for a given insurance product to be placed in one of the several categories of contracts defined in the tax law.

We have made two adjustments to the series for the current edition: First, since the questions in this segment are focused on legal and accounting issues, our actuarial contributors have deferred to members of those professions, and the panel for Part III does not include an actuary. Second, due to the breadth of the topic of deference, we will expand the dialogue to a fourth installment, to appear in the next issue of TAXING TIMES, where we will wrap up our journey with an examination of deference to NAIC annual statement accounting in areas such as premiums, investment income, hedging and expenses.

I am eager to welcome back our panel of highly experienced tax professionals. Peter Winslow of Scribner, Hall & Thompson, LLP developed the concept for the dialogue and continues to serve skillfully as moderator. Peter is joined by Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the Internal Revenue Service (IRS) Chief Counsel's Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman, LLP. Susan, John and Peter were all active in the legislative process "in the beginning"—during the enactment of the Tax Reform Act of 1984.

Enjoy the conversation!



Peter Winslow: This is the third installment of our extended dialogue on the issue of federal tax law's deference to insurance regulation rules. We have covered in some depth the deference issue as it relates to tax reserves and to policyholder tax issues. This installment will cover what I will call insurance classification issues, including the existential question—what is insurance? To what extent does guidance from the NAIC or state regulators matter in answering this question?

In the context of life company taxation, our discussion will cover issues such as whether the company will be taxed as an insurance company, whether an insurance company will be classified as a life or nonlife company, and, of course, captive issues. Whether a transaction qualifies as reinsurance or something else also comes within this broad "what is insurance?" inquiry.

As in the past, I want to begin the discussion with our "In the Beginning" panelists, Susan Hotine and John Adney, who were both instrumental in the development of the 1984 Act, which forms the basis of current law. Susan, can you please describe for us what Congress did in the 1984 Act on the basic issues of classification of a company as an insurance company and/or a life insurance company?

LIFE INSURANCE COMPANY QUALIFICATION

Susan Hotine: Prior to the 1984 Act, the term "insurance company" was defined in the regulations under section 801 of the 1954 Internal Revenue Code as meaning "a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring

of risks underwritten by insurance companies.”⁴ The regulation goes on to say that, although the company’s name, charter powers and regulation as an insurance company under state laws are significant, it is the character of the business activity actually done in the taxable year that determines whether the company is taxable as an insurance company.

While an insurance company was defined under pre-1984 law in the regulations, the definition of a life insurance company was set forth in the Code. The 1984 Act retained the tax definition of a life insurance company that had been in the Code under prior law—“an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if (1) its life insurance reserves⁵... , plus (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves.” But the 1984 Act went further and defined in the Code itself the term “insurance company” for purposes of determining whether a company is a life insurance company. That Code definition is very much like the definition of an insurance company that is in the regulations developed under prior law except that, instead of looking to the primary and predominant business activity, it requires that more than half of the company’s business during the taxable year be the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies.

Peter: Do these Code and regulation definitions give any explicit deference to the NAIC or state regulators in defining an insurance company or life insurance company?

Susan: No. Looking at both prior law regulations and the current Code, neither gives deference to the NAIC or state insurance regulators for purposes of determining whether a company is a life insurance company for tax purposes.⁶ Like the definition of an insurance company under the regulations developed under prior law, the Code definition seems to present an activities

test. The 1984 Act legislative history points out that whether more than half the business activity is related to the issuing of insurance and annuity contracts depends on the facts and circumstances, and that the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from the various business activities are all factors to be considered.⁷ Again, there does not seem to be a deference shown to the NAIC or state insurance regulators.

Peter: How about the pre-1984 Act case law in interpreting these provisions? John, did the courts use the regulations’ definition of a life insurance company?

John Adney: Yes they did, Peter. By way of example, in deciding whether credit life insurance companies should be taxed as life insurers under part I of Subchapter L, the courts looked to a construction of the Code and the Treasury regulations rather than simply the companies’ status under state law. In *United States v. Consumer Life Insurance Co.*,⁸ the Supreme Court focused on the reserves and risks assumed by the taxpayer as reinsurer of credit life coverage. The Court conducted a detailed examination of the statutory rules and the regulations, leading it to reject the IRS contention that “reserves follow the risk” and to uphold the taxpayer’s treatment as a part I life insurance company.⁹ Part I treatment also was upheld in the oft-cited decision in *Alinco Life Insurance Co. v. United States*.¹⁰ In that case, the Court of Claims cited the regulations chapter and verse to turn aside a broad-based government attack on Alinco’s tax treatment, a contention premised on the point that under pre-1959 Act law, the insurer could operate largely tax-free. Yet another credit life decision in the taxpayer’s favor was *Central National Life Insurance Co. v. United States*.¹¹

Another good example would be the decision of the Court of Appeals for the Fifth Circuit in *Group Life & Health Insurance Co. v. U.S.*¹² At issue there was whether the taxpayer (the Blue Cross/Blue Shield company in Texas) could claim life insurance reserve treatment for its guaranteed renewable health insurance contracts, and thus be taxed under part I, even though it did not maintain an “additional reserve” as the regulations required.¹³ The taxpayer argued that because the Texas State Board of Insurance did not require it to post the additional reserve, that trumped the regulation, but the court sided with the regulation and the taxpayer lost. As regards deference to state law, the Fifth Circuit made this quotable observation: “While Congress has occasionally enacted Federal tax provisions which depend on underlying state definitions and thus result in varying treatment between taxpayers of the several states, the life insurance company provisions of the Code evidence an intent that insurance companies are taxed uniformly.” This prompted the court to adhere closely to the text of the regulations defining noncancellable and guaranteed renewable contracts.¹⁴

Looking at both prior law regulations and the current Code, neither gives deference to the NAIC or state insurance regulators for purposes of determining whether a company is a life insurance company for tax purposes.



Peter: What you are saying, I think, is that the courts (and the IRS) looked to the Code and the Treasury regulations in determining life insurance company qualification, quite apart from a company's treatment under state regulation and even in contravention of it. But don't the Code's rules contain an embedded element of deference to state regulation where they depend to some degree on statutory reserve classifications and accounting?

John: I believe they do. Much of Subchapter L, for both part I life companies and part II nonlife companies, is premised on state law rules and concepts generally and on the NAIC annual statement treatment in particular. As used in the elements of the section 816 qualification fraction carried over from prior law, life insurance reserves, with a few exceptions, must be "required by law," and "total reserves" include "all other reserves required by law."¹⁵ The law Congress referred to is state law, showing at least some degree of deference to state law rules in the company tax definition. In sum, one can view the deference to state law as "necessary but not sufficient" to define what an insurance company or a life insurance company is for federal income tax purposes.

On the other hand, perhaps a striking example of non-deference to state law in the life insurance company definition is found in section 816(f), a provision new in the 1984 law. According to that rule, solely for purposes of determining whether an insurance company is to be taxed under part I, reserves for contracts not containing permanent guarantees with respect to life, accident, or health contingencies are excluded from both the numerator and the denominator of the qualification fraction. This was intended to keep state-chartered life insurers subject to taxation under part I despite their issuance of large amounts of pension business that lacked permanent annuity purchase rate guarantees.

Peter: I love your characterization of the deference issue for life insurance company classification for tax as "necessary but not sufficient." I agree. Sheryl, is that the way the IRS National Office has viewed the deference issue in this context?

Sheryl Flum: I would say "helpful but not sufficient." The IRS National Office has taken the position that state qualification as an insurance company is but one factor to be considered in determining if an entity is an insurance company (life or non-life) for federal tax purposes, but is not necessarily the deciding factor. Notwithstanding that a company is regulated as an insurance company under state laws and regulations, the IRS has more than once asserted that such company is not an insurance company for tax purposes.

In *R.V.I. Guaranty Co. Ltd. v. Commissioner*,¹⁶ the government argued that the nonlife company taxpayer was not an insurance company for tax purposes notwithstanding that its state of domicile regulated it as an insurance company. In rejecting the government's argument, the Tax Court emphasized the importance of state insurance regulation in the determination of whether the company should be considered an insurance company for tax purposes. The court in *R.V.I.* found that R.V.I.'s policies were insurance within the "commonly accepted" sense, satisfying one prong of the common law test for "insurance," because R.V.I.'s policies were treated as insurance for nontax purposes and R.V.I. was organized, operated and regulated as an insurance company. Since the opinion is recent, and the IRS has not publicly responded since the opinion was issued, it is unclear whether this decision will impact the IRS' view.

On the "necessary" point, I don't think the IRS views state characterization as an insurance company as a requirement for federal qualification **if** the activities of the company otherwise meet the "insurance company" tests. For example, some obligor companies that are not insurance companies for state regulatory purposes may qualify as insurance companies for federal income tax purposes.

Peter: So, for insurance company status for tax purposes, the IRS National Office's position is that state regulation as an insurance company is helpful, but, depending on the circumstances, neither necessary nor sufficient. But, my guess is that the not-necessary conclusion generally applies to companies issuing property/casualty-type products, like warranty insurers. I cannot think off the top of my head of any instance where the IRS has said that a company qualifies as an insurance company where it issues life insurance-type products, but is not regulated as an insurance company. On the other hand, there are many instances where the IRS has ruled that a company regulated as a life insurance company does not qualify as an insurance company for tax purposes either because it is dormant or because its investment or non-insurance activity is disproportionate to its insurance activity—the not-sufficient part of the IRS' position.

Mark Smith: I think we're all saying the same thing, but want to be sure. First we analyze whether a company is an insurance

company. For this purpose, state regulation is “helpful but not sufficient.” Second, if the company is an insurance company, we analyze whether or not it is a life insurance company. For this purpose, state regulation is “necessary but not sufficient,” at least as a practical matter. This is because an insurance company is a life insurance company if more than half its reserves are life insurance reserves, and there are at least indirect requirements that can only be met by a company that is regulated as an insurer. For example, a company qualifies as a life insurance company only if more than half its reserves are life insurance reserves. And as John points out, only reserves “required by law” are life insurance reserves. One might think of this as an indirect deference to state law as to life insurance company characterization, but not as to insurance company characterization more generally.

In Part II of our dialogue we talked about limited situations in which the IRS has treated non-state regulated life insurance contracts as life insurance contracts.¹⁷ Might there be circumstances where the issuer of such contracts is eligible for taxation as an insurance company, but not as a life insurance company, under this framework? The question is rhetorical and reserved for another day or a real-life fact pattern.

It’s hard to talk about deference in this context without asking whether the rules we’ve described make sense. There is a classic tension between certainty, on the one hand, and other principles, such as horizontal equity and clear reflection of income, on the other. Here, a rule that automatically follows a company’s state law characterization would provide certainty, but not necessarily the best answer in all cases. A company chartered and regulated as an insurance company might not conduct its business as an insurance company. Or vice versa—a company that is not chartered and regulated as an insurance company might nevertheless issue products that are so similar to insurance or life insurance contracts that the best answer would be to use the same accounting methods as issuers of insurance or life insurance contracts.

The IRS’ practice of treating some corporate taxpayers as nonlife insurance companies even if they are not regulated as insurance companies seems correct, even obvious, in situations such as the extended warranty situations that Sheryl mentioned. And in any event, the IRS is understandably reluctant to cede authority to a nontax regulator to make what are basically tax determinations. As to life insurance company status, however, practical considerations weigh in favor of the indirect deference that generally prevents a nonregulated company from being taxed as a life insurer. For example, it may be difficult to apply section 807(d) to reserves of a company that is not otherwise subject to CRVM or CARVM, or that otherwise does not file an annual statement or have even a starting point for applying the statutory reserve cap.

All this could get quite messy in practice. Fortunately, the issue doesn’t come up all that often for most of us.

John: Peter, let me interject a comment. In saying “necessary but not sufficient,” I was thinking of the introductory regulation under the 1959 law, which defined the term “insurance company.” (I was raised on the 1959 law.) That regulation intones that “though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done” that determines its tax treatment.¹⁸ So, I will agree with you, Sheryl and Mark, by changing my answer to say “significant but not sufficient.” And as Susan mentioned earlier, in 1984 Congress altered the standard articulated at the beginning of that regulation, so that instead of looking to the primary and predominant business activity of a company to determine its status as an insurance company (or not), the law now requires that more than half of the company’s business during the taxable year consist of issuing or reinsuring insurance and annuity contracts.

WHAT IS INSURANCE?

Peter: So far, our discussion has focused on the company’s tax status as, first, an insurance company, and then a life insurance company. I want to now touch on the more fundamental question, “what is insurance?” to see what role deference plays in answering that question. Several things occur to me when thinking about this issue from a state insurance regulatory standpoint. First, there is a body of law dealing with the McCarran-Ferguson Act and the scope of the “business of insurance” subject to state regulation. Also, related to this is the case law dealing with claim priority statutes that apply when an insolvent insurer is liquidated. Those claim priority statutes give preference to the claims of policyholders over other general creditors, so it matters who is considered an insurance policyholder. There are not many situations where this case law dealing with these insurance regulatory issues has had much influence on tax cases. But, recently, the Tax Court in the *R.V.I.* case did cite the McCarran-Ferguson Act. On the other hand, I know that a significant factor in deciding whether a captive qualifies as an insurance company is whether the risk covered is insurance as that term is commonly understood. Mark, can you help sort this out?

Mark: Well, that’s a good question and one worth developing. Rather than defer to the statutory accounting characterization as insurance, the tax law definition of insurance is generally thought to require that three elements be satisfied: (1) the risk involved must be an insurance risk; (2) the risk must be shifted to the insurer and distributed along the lines of the law of large numbers; and (3) the arrangement must constitute insurance in the commonly accepted sense, or some variation of that phrase.¹⁹ Statutory accounting has a role to play separately in each element of this tax definition, even though there is no deference as to the bottom-line characterization.

As for the first and third elements—presence of an insurance risk, and insurance in the commonly accepted sense—the case that Sheryl and you mentioned, *R.V.I. Guaranty Co. Ltd.*, is a perfect example of a court giving careful consideration to a regulator’s treatment of an arrangement to decide whether the risks are insurance risks, and whether the arrangement can be considered insurance in the commonly accepted sense. Of course, the interests of a regulator are sometimes different from the interests of the IRS in this regard. A regulator’s incentive may sometimes favor insurance characterization in order to retain jurisdiction to regulate, whereas the IRS’ incentive may sometimes be to disqualify an arrangement from the accounting that is afforded insurance under Subchapter L. Still, it’s hard to imagine any court, or the IRS for that matter, disregarding the regulatory treatment of an arrangement as insurance when deciding whether the risks are insurance risks, or the arrangement is insurance in the commonly accepted sense.

Peter: What about the second element of the definition—risk shifting and risk distribution?

Mark: That is more interesting. It would be easy to label a regulatory conclusion that there is risk shifting the way we earlier labeled other issues, that is, “helpful but not sufficient” or “necessary but not sufficient” for tax purposes. Risk shifting in particular is different, and these labels would not do the issue justice. Let’s unbundle that.

One reason why an arrangement might not involve risk shifting is based on the rights and responsibilities under a purported insurance contract itself. The risks at issue under the contract might themselves be remote, such as the proverbial hurricane insurance in Kansas, or kidnapping insurance in North Dakota. Or, the risks at issue might be so certain to happen that in substance there is no uncertainty at all, but rather, in substance, a financing. Or, the attachment points and policy limits might be set in a way that the expected cash flows are all but certain. With the important assistance of the actuarial profession, statutory accounting is well-equipped to analyze whether there is risk shifting based on the insured risks and the terms of a particular contract. Tax might or might not follow, depending on the IRS’ view of the substance of the arrangement and the application of general tax principles in a particular case.

Another factor that might prevent risk shifting for tax purposes might be the relationship between the parties. Despite the rule of *Moline Properties*,²⁰ which gives effect to the separate existence of a corporation, the IRS’ long-held view was that an arrangement between corporate members of the same “economic family” could not qualify as insurance.²¹ The IRS wisely abandoned that theory after the loss of several important court cases,²² but still applies a so-called “balance sheet test” to disqualify direct insurance arrangements between a parent and its wholly owned insurance



company if there is insufficient unrelated business. The theory underlying this test is that the payment of a parent’s claim by a wholly owned insurer reduces the value of the insurer on the parent’s balance sheet, such that there is no shifting of risk from the parent to the subsidiary. This is not to say that the relationship of the parties is wholly irrelevant for statutory accounting purposes. In the case of retroactive insurance, for example, the accounting treatment may sometimes depend on whether the ceding company and assuming company are related or unrelated.²³ But, for tax, this factor has in the past taken on special importance.

Yet another reason why an arrangement might flunk risk transfer may involve the capitalization of the company, or the responsibilities of other parties with regard to the same risks. For example, the IRS sometimes analyzes whether risk has shifted according to the insurer’s wherewithal to satisfy claims, or according to the existence of side arrangements and guarantees. There is not necessarily a direct correspondence between the IRS’ approach and the rules that might apply for statutory accounting purposes. Based on the *Malome & Hyde case*,²⁴ the IRS has historically attached more importance to the existence of a guaranty, for example, than has statutory accounting.

Sheryl: Another factor the IRS has traditionally considered in determining whether there is risk shifting and distribution is



identifying the person (or entity) that has the economic risk of loss. In its published guidance, the IRS has rejected risk distribution when a large number of units are covered if all of the units have the same owner. Under this theory, if a company issued a policy to the owner of a fleet of vehicles, and that was the only policy issued by the company, a state may regulate the company as an insurance company, but the IRS would not deem that company to be an insurance company for federal tax purposes. It should be noted that the Tax Court, in *Securitas* and *Rent-A-Center*, rejected the IRS' position. However, the IRS has not officially rejected this theory. Also, this risk of economic loss theory is difficult to apply in a life insurance arrangement.

Peter: How do your observations on the IRS' risk shifting analysis relate to the risk distribution requirement of the test?

Mark: Sometimes, the risk shifting issue may be conflated by the IRS with the issue of risk distribution for an arrangement to qualify as insurance. *TAXING TIMES* readers are likely more familiar than anyone with the operation of the "law of large numbers," which at its core explains the requirement of risk distribution. I've been told that an actuary would look at a large pool of similar but statistically independent risks and conclude quite easily whether the law of large numbers applies, without even asking which risks belong to whom. The IRS, in contrast, has historically been quite conservative in this area. This is because for tax purposes, tax-deductible reserves are a departure from the all-events test and economic performance requirement that ordinarily apply to a single accrual basis taxpayer. There are certainly limits to deference on risk distribution under current guidance,²⁸ but litigation losses by the IRS could cause both the government and companies to rethink this area.

IS IT REINSURANCE?

Peter: Sometimes it is unclear, at least to me, on a related "what is insurance?" issue: What role does NAIC accounting play on

the question of what qualifies as reinsurance for tax purposes? For example, if a transaction has transferred enough insurance risk to be treated as reinsurance under SSAP No. 61R, does that mean it will qualify as reinsurance for tax purposes?

Mark: That's a good question. Nothing is automatic. The IRS would rightfully give close scrutiny to a reinsurance arrangement that does not qualify as such under SSAP No. 61R but is treated as reinsurance for federal income tax purposes. In 2005, the IRS requested comments on "finite risk transactions,"³⁰ partly in response to press reports about reinsurance arrangements that transferred a limited amount of risk and were accounted for as reinsurance by one party and as a financing by the other. No guidance resulted from that request for comments. At a minimum, it illustrates that the IRS is aware of the issues that may come up in close cases. One would ordinarily expect qualification as reinsurance under SSAP No. 61R to be a prerequisite—"necessary but not sufficient"—to reinsurance characterization for tax purposes, but even that might not always be the case. For example, if two parties to a transaction account for a transaction inconsistently, one would expect the IRS to assert that it could depart from annual statement accounting on at least one side of the transaction to correct the inconsistency or to tax the arrangement according to its substance.

Reinsurance is analyzed similarly to direct insurance for many purposes in Subchapter L, and as with direct insurance, it is important that reinsurance entail sufficient risk shifting to be accounted for as such under Subchapter L. I would point out an important distinction, though. A few minutes ago we were talking about risk shifting in the context of direct insurance and unbundling some of the reasons why there might not be risk shifting in a particular case. One category of issues—the relationships of the parties—is significantly less important to reinsurance characterization for one important reason. The IRS and courts have both made clear that for reinsurance, the analysis of risk shifting and risk distribution looks through to the underlying policyholders.³¹ This is a factor that can cut either favorably for insurance (there are few or no issues as to arrangements between a parent and subsidiary) or unfavorably (in the captive insurance context, a direct policyholder cannot route its risks through a fronting company in order to avoid disqualification as direct insurance). These distinctions have their roots in tax and may or may not even be relevant to statutory accounting in some cases. Hence, the caution that nothing is automatic.

DEFERRED ACQUISITION COST (DAC) CLASSIFICATION OF THE CONTRACT

Peter: Sometimes classification of the type of insurance coverage can make a difference in company taxation. For example, whether an accident and health insurance contract qualifies as guaranteed renewable or cancellable can make a difference on which tax reserve rules apply and on whether the contract is sub-

ject to being “DACed.” John, does the tax law defer to NAIC definitions to classify the type of insurance for purposes of life insurance company tax?

John: There is a deference of sorts to the state law definitions of these terms, in that the tax law contains its own definitions of “noncancellable” and “guaranteed renewable,” but these are modeled on the state law concepts. The regulations under former section 801, in addressing the terms used in the life insurance company qualification ratio now contained in section 816, define a noncancellable contract as one “which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums ... must be carried to cover that obligation.”³² Thus, the contract must be renewable by the policyholder at a stated premium—the regulation says renewable at least to age 60—and there must be an additional reserve related to the renewal obligation.³³ A guaranteed renewable contract is defined similarly in the regulations, except that the renewal premiums may be adjusted “by classes in accordance with [the insurer’s] experience under the type of policy involved.”³⁴ Hence, to be considered guaranteed renewable under the tax law, an additional reserve must be maintained in respect of the obligation to renew, a reserve which together with the unearned premiums is often called the active lives reserve. The need for this additional reserve was the very issue in the *Group Life & Health* case I discussed earlier. Recall that in that case, the insurer’s state regulator did not require the additional reserve, but the court followed the former section 801 regulations and said the additional reserve must be held in order for the contract to be considered guaranteed renewable, to allow the insurer to claim life insurance reserve treatment for its health insurance contracts.

Peter: So, to see whether we have a guaranteed renewable contract, we first start with a test similar to the NAIC definition, but then add another requirement that there be an additional reserve to reflect a risk beyond the current contract year. I believe the IRS also issued a ruling some time ago that says that, if the insurer retains the right to cancel all coverage in a state, the contract is not guaranteed renewable.³⁵ This seems a departure from the regulatory definition of guaranteed renewable, and may not be right.

John: This classification issue may have a big tax impact. Today, the qualification of a contract as guaranteed renewable is significant not only for reserve classification (which can affect life insurance company status) and for application of the section 848 DAC tax, but also in the case of a long-term care insurance contract. The ability of such a contract to be “qualified” under section 7702B depends in part on whether it is guaranteed renewable. So, the regulations’ definitions of noncancellable and guaranteed renewable remain important. That said, those defi-

nitions appear to be close to the related state law concepts, with the exception that state law varies from the regulations’ notion that contract renewability can cease at age 60, and the possible exception you mentioned, Peter.

Peter: I think that winds up this segment of our dialogue. As with our first two dialogues dealing with tax reserves and policyholder taxation, the degree of deference to the NAIC and state regulation on the insurance classification tax issues seemed to be a mixed bag. It depends on the Code section we are interpreting and on whether it is the IRS or the courts talking.

The next, and final, installment of our dialogue will be a catch-all discussion that will cover the deference question as it relates to NAIC annual statement accounting. Until then, on behalf of our *TAXING TIMES* readers, I want to once again thank our panelists for their participation in this interesting dialogue.

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of their current or former employers. ■

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END NOTES

¹ **Disclaimer:** The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

² Peter Winslow et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part I: Tax Reserves," *TAXING TIMES*, Vol. 11, Issue 2, at 22 (June 2015).

³ Peter Winslow et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part II: Policyholder Issues," *TAXING TIMES*, Vol. 11, Issue 3, at 13 (October 2015).

⁴ Treas. Reg. § 1.801-3(a).

⁵ Section 816(a).

⁶ Note that as of 2004, the definition of an insurance company applicable for life insurance companies also applies to nonlife insurance companies. Section 831(c).

⁷ Staff of the J. Comm. on Tax'n, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* ("1984 Blue Book"), at 582-583.

⁸ 430 U.S. 725 (1977).

⁹ Life insurance companies are taxed under Part I of Subchapter L of the Code. Nonlife insurance companies are taxed under Part II of Subchapter L.

¹⁰ 373 F.2d 336 (Ct. Cl. 1967).

¹¹ 574 F.2d 1067 (Ct. Cl. 1978).

¹² 434 F.2d 115 (5th Cir. 1970).

¹³ Treas. Reg. § 1.801-3(d).

¹⁴ 434 F.2d at 118-120.

¹⁵ Section 816(b)(2) and (c).

¹⁶ 145 T.C. No. 9 (Sept. 21, 2015).

¹⁷ The discussion appears at Peter Winslow et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part II: Policyholder Tax Issues," *TAXING TIMES*, Vol. 11, Issue 3, at 13 (October 2015). See also PLR 200002030 (Oct. 15, 1999) and PLR 199921036 (Feb. 26, 1999) (both treating death benefits paid under employee welfare benefits plans as life insurance proceeds); *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950) (amounts received from New York Stock Exchange Gratuity Fund treated as life insurance proceeds, before the 1984 enactment of section 7702).

¹⁸ Treas. Reg. § 1.801-3(a)(1).

¹⁹ *AMERCO v. Commissioner*, 96 T.C. 18 (1991), *aff'd*, 979 F.2d 162 (9th Cir. 1992).

²⁰ *Moline Props., Inc. v. Commissioner*, 319 U.S. 436 (1943).

²¹ See, e.g., Rev. Rul. 77-316, 1977-2 C.B. 53, *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348; Rev. Rul. 78-277, 1978-2 C.B. 268, *obsoleted* by Rev. Rul. 2001-31, 2001-1 C.B. 1348.

²² Rev. Rul. 2001-31, 2001-1 C.B. 1348.

²³ See, e.g., SSAP No. 62, paragraph 30.d, treating retroactive reinsurance as prospective reinsurance in the case of an intercompany reinsurance agreement among certain companies that are commonly controlled.

²⁴ *Malone & Hyde Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995).

²⁵ See Rev. Rul. 2005-40, 2005-2 C.B. 4.

²⁶ *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225.

²⁷ *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014).

²⁸ For example, in Rev. Rul. 2005-40, 2005-2 C.B. 4, the IRS concluded that an arrangement with an insurer who insures only a single policyholder, or who insures a policyholder representing 90 percent of the business of the company, does not satisfy the insurance requirement of risk distribution. This conclusion was not based on any statutory accounting guidance.

²⁹ In *Rent-A-Center* and *Securitas*, the Tax Court concluded risk distribution was present in situations involving a large number of independent risk units and a concentration of risks in a small number of policyholders. The court's opinions did not elaborate on the relevance of the number of policyholders or concentration of risks.

³⁰ Notice 2005-49, 2005-2 C.B. 14.

³¹ See Rev. Rul. 2009-26, 2009-38 I.R.B. 366 (concluding that the issuer of a single reinsurance treaty with a single ceding company qualifies as an insurance company based on the policies underlying the reinsurance contract); *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396 (3rd Cir. 1990) (denying deduction for premiums paid to commercial insurers where the risks were subsequently reinsured with a captive affiliate).

³² Treas. Reg. § 1.801-3(c).

³³ *Id.*

³⁴ Treas. Reg. § 1.801-3(d).

³⁵ PLR 8601013 (Sept. 30, 1985).

Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves

By Peter H. Winslow

In Notice 2010-29,¹ the Internal Revenue Service (IRS) provided “interim” guidance on the treatment of tax reserves for variable annuity contracts computed under Actuarial Guideline (AG) 43.² The Notice announced the IRS National Office’s interim conclusion that only the Standard Scenario Amount portion of AG 43 reserves, and not the Conditional Tail Expectation Amount (CTE Amount), should be included in federally prescribed reserves under I.R.C. § 807(d). No rationale for this conclusion was offered. The Notice did not say whether the CTE Amount should be included in “statutory reserves” as defined in I.R.C. § 807(d)(6) for purposes of capping a contract’s deductible federally prescribed reserves by the amount of statutory reserves allocable to the contract. Instead, the reserve capping issue, left unresolved by the Notice, was added to the IRS’ Priority Guidance Plan where it has remained an open project for several years. Recently the scope of the uncompleted project was updated and revised in the 2015–2016 Priority Guidance Plan to refer more generally to the tax treatment of stochastic reserves (including VM-20 principle-based reserves (PBR) for life insurance and possibly VM-22 for fixed annuities) and to other tax reserve matters related to stochastic reserves, and not just the statutory reserves cap. This expansion of the issues being considered by the IRS for guidance is beneficial for several reasons. Guidance will be needed on PBR issues when, and if, VM-20 for life insurance policies becomes effective—commonly expected to be for 2017. More importantly, the interim conclusion of Notice 2010-29 that the CTE Amount cannot qualify as federally prescribed reserves needs to be further examined, especially in light of recent court decisions that call into question the Notice’s interim guidance to the extent it departs from National Association of Insurance Commissioners (NAIC) reserve requirements.³

This article presents legal analysis of the issues relating to whether the CTE Amount in AG 43 and the stochastic component of PBR under VM-20 are included in federally prescribed reserves and concludes that, in this author’s opinion, they are. The article also presents options for giving effect to the tax adjustments required by I.R.C. § 807(d) to the extent they are relevant to stochastic reserves.

BASIC TAX RESERVE RULES

The computation of life insurance reserves under I.R.C. § 807(d) involves a three-step approach. First, an actuarial reserve—the federally prescribed reserve—is computed on a contract-by-contract basis. Then, this reserve is compared to the net surrender value of the contract. The larger amount is the tax reserve, except, under the final step, the deductible tax reserve for a contract is capped at the amount of statutory reserves. “Statutory reserves” for this purpose generally refers to the aggregate amount of reserves with respect to the contract that are set forth in the company’s annual statement.⁴

The computation of the federally prescribed reserve begins with the company’s statutory reserve and modifies that reserve to take into account three requirements of I.R.C. § 807(d): (1) the tax reserve method applicable to the contract; (2) the prevailing state assumed interest rate or the applicable federal interest rate (AFIR), whichever is larger; and (3) the prevailing commissioners’ standard tables for mortality or morbidity. Other related Internal Revenue Code (“Code”) sections require further adjustments, eliminating from the federally prescribed reserve any portions attributable to net deferred and uncollected premiums, excess interest guaranteed beyond the end of the taxable year, and deficiency reserves. Except for these prescribed adjustments and several other miscellaneous adjustments applicable to specific types of contracts, the methods and assumptions employed in computing tax reserves should be consistent with those used in computing the company’s statutory reserves.⁵

STOCHASTIC RESERVES IN THE TAX RESERVE METHOD⁶

Section 807(d)(3) defines the applicable tax reserve method for the federally prescribed reserve of a life insurance or annuity contract to be the Commissioners’ Reserve Valuation Method (CRVM) or the Commissioners’ Annuity Reserve Valuation Method (CARVM), respectively, as prescribed by the NAIC in effect on the date of the issuance of the contract. Therefore, by its terms, the literal language of I.R.C. § 807(d) requires the federally prescribed reserve to include the CTE Amount of AG 43 and the stochastic component of PBR under VM-20. The background section of AG 43 makes clear that the entire reserve is the NAIC’s interpretation of CARVM as described in the Standard Valuation Law (SVL). Similarly, Section 1 of VM-20 states that the entire PBR, including the stochastic component, is the NAIC-prescribed CRVM. Even if it could be argued that AG 43 and VM-20 are not CARVM and CRVM, respectively, it does not matter; the tax reserve method would be the same. That is because if a contract is not covered by CARVM or CRVM, I.R.C. § 807(d) nevertheless provides that the method prescribed by the NAIC for that type of contract at the date of issuance must be used. Thus, according to the statute, AG 43 in its entirety became, and PBR in its entirety will become, the

applicable NAIC-prescribed methods for tax purposes for contracts issued after the NAIC adoption date (note that AG 43 was applied for statutory reserves retroactively to all contracts issued on or after 1981).

If the statute is so clear that the stochastic reserve component of AG 43 is included in CARVM as prescribed by the NAIC, how did the IRS reach a contrary tentative conclusion in Notice 2010-29 that the federally prescribed reserve is limited to the Standard Scenario Amount? The IRS has long held the view that absolute deference to NAIC accounting and reserves requirements is not how the tax law should be interpreted. From the IRS' perspective, the NAIC has a different goal in setting reserve standards from Congress in enacting tax statutes. The NAIC is concerned with solvency whereas the federal tax regime attempts to provide a set of rules to provide a measure of annual income that should be taxed. As a result, in litigation and rulings, the IRS has asserted that it is entitled to place an interpretative gloss on the provisions of Subchapter L of the Code applicable to insurance companies and depart from deference to the NAIC where such deference would be inconsistent with Congress' perceived goals. As the IRS stated in Notice 2008-18,⁷ in which it expressed concern with allowing tax deductions for stochastic reserves:

Notwithstanding the deference accorded statutory accounting under Subchapter L, the Treasury Department and IRS do not anticipate changes to existing guidance that requires that tax principles override statutory accounting principles in appropriate cases.

In light of recent court decisions, this position of the IRS probably should be reconsidered. Perhaps the most basic rule of statutory construction is that the plain language of the statute must be followed; if the statute is clear, courts should not examine legislative history in an attempt to discern congressional intent.⁸ In order to go beyond the statutory language, it is first necessary for the court to find that there is an ambiguity in the statute. This fundamental principle was recently reconfirmed by the Supreme Court in a case upholding the tax provisions of the Affordable Care Act, although the justices could not agree on whether that statute, in fact, is ambiguous.⁹ For the tax reserve method, the plain language of the statute is clear—deference to the NAIC-prescribed method is required. This conclusion is supported by three recent cases. In *American Financial*,¹⁰ the Sixth Circuit stated definitively:

The point is that, when it comes to the federal-tax consequences of increasing or decreasing their annuity reserves, insurance companies must follow the reserve-valuation method (the CARVM) “prescribed” by the National Association in effect on the date the company issued the annuities.

If the statute is so clear that the stochastic reserve component of AG 43 is included in CARVM as prescribed by the NAIC, how did the IRS reach a contrary tentative conclusion in Notice 2010-29 that the federally prescribed reserve is limited to the Standard Scenario Amount?

In that case, in order to resort to legislative history in a case involving an interpretation of AG 33, the IRS argued that the meaning of the word “prescribed” to ascertain the NAIC-prescribed tax reserve method is ambiguous. The court disagreed, but went further to point out that even if this “glimmer of ambiguity” permits review of the legislative history, it does not supersede the statute. In other words, the court found that the statute’s deference to the NAIC in the tax return method is much clearer and more definitive than the general principles of perceived congressional intent that could be gleaned from the legislative history.

This same deference to the NAIC has been followed in two other cases in analogous circumstances dealing with reserves for property/casualty insurance companies.¹¹ Like the provisions applicable to reserves for life insurance and annuity contracts, the comparable provisions of Subchapter L for nonlife claim reserves defer to NAIC annual statement accounting.¹² In *State Farm*, the Seventh Circuit held that estimates of compensatory extracontractual obligations are required to be included in deductible loss reserves because NAIC accounting requires that treatment. The court rejected the IRS’ attempt to depart from NAIC reserve accounting merely because extracontractual obligations may not be unpaid losses “on” an insurance contract. Similarly, the Tax Court in the *Acuity* case involving the reasonableness of a taxpayer’s loss reserve estimates, cited the *State Farm* case and quoted the case of *Sears, Roebuck*,¹³ reconfirming that deference to state regulators’ reserve requirements “are not some intrusion on federal tax policy; using their annual statement is federal tax law.”

Even if it were to be assumed that there is some “glimmer of ambiguity” in I.R.C. § 807(d) as to what the NAIC-prescribed method actually is, it is unlikely that a court would limit the federally prescribed reserve to AG 43’s or PBR’s net premium portion of the reserve—which, standing alone, is not the NAIC-prescribed method. Certainly, Notice 2010-29 is not entitled

to deference simply because the IRS has stated its position publicly. For a court to grant this type of “Skidmore”¹⁴ deference to an IRS publication of its position, the IRS must provide persuasive reasoned analysis for its conclusion.¹⁵ This required reasoning is lacking in Notice 2010-29.

A court would need to rely on some clear congressional intent revealed in the legislative history to arrive at this result. It has been suggested that the following quote from the legislative history supports the exclusion of stochastic reserves from federally prescribed reserves.

The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. To avoid State-by-State variations, the rules prescribed in the bill are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.¹⁶

The inference apparently gleaned from this quote, coupled with the statutory provisions designed to require adjustments to net premium reserves, is that stochastic reserves are not allowable because they permit too much discretion to companies to increase reserves above the “minimum reserve that most States would require,” and that company-specific assumptions, such as lapse rates, are inconsistent with a perceived congressional intent to avoid reserve variations so that companies do not receive varying tax reserve deductions for similar products.

This argument is reading too much into the legislative history, and a court would be reluctant to rely on this committee report statement to override the plain language of the statute. The quote from the legislative history says that Congress intended to avoid state-by-state variations in minimum tax reserve standards; it does not say that the law requires company-by-company conformity in tax reserve amounts. Moreover, there are several instances in the statute and legislative history that actually do permit company-specific assumptions to govern,¹⁷ as well as other statements in the legislative history that reinforce the required deference to the NAIC-prescribed tax reserve method.¹⁸

Another rationale sometimes offered in support of this conclusion is hinted at in Notice 2008-18. The possible rationale is based on a rule of statutory construction that the IRS sometimes has referred to as the “Cambridge Doctrine”¹⁹ because it is derived from an early Supreme Court case that incorporates that name.²⁰ Under this rule of statutory construction of tax statutes, Congress is presumed to have used a term of art according to its legal significance at the time the tax statute was enacted. In the case of tax reserves for annuity contracts, the argument goes,

Congress must have intended that only reserves computed using a deterministic net premium reserve methodology would qualify as NAIC-prescribed tax reserves because that was the understanding of the meaning of CARVM under the SVL’s definition in 1984 when I.R.C. § 807 was enacted. Further support for this interpretation of the statute is that the other adjustments to statutory reserves required by I.R.C. § 807 (*e.g.*, mortality, interest, deficiency reserves) contemplate a 1984-era deterministic net premium reserve methodology.

There are significant problems with application of the Cambridge Doctrine to tax reserves, but the most important problem is the plain language of I.R.C. § 807(d) itself. The statutory construction principle referred to by the IRS as the Cambridge Doctrine potentially could have application here if the statute merely had required use of CRVM or CARVM without more, but that is not what the statute says. Rather, I.R.C. § 807(d) explicitly defers to the method prescribed by the NAIC. Congress understood that the NAIC could adopt new reserving methodologies and specifically referred to this possibility in the legislative history.²¹ To resolve what happens if the NAIC adopts a new reserve method, the statute requires use of the NAIC-prescribed method in effect at the time a contract is issued. Thus, I.R.C. § 807(d) mandates deference to the NAIC even if the NAIC changes its prescribed reserve method for a particular class of contracts. Moreover, I.R.C. § 807(d)(3) requires taxpayers to use the NAIC-prescribed method even if the NAIC specifies something other than CRVM or CARVM. Simply put, the Cambridge



Doctrine is of little help in interpreting I.R.C. § 807(d) and determining the proper tax reserve method required to be used.

Although the Cambridge Doctrine should not apply here, another rule of statutory construction probably does. That rule is that all parts of a statute, if possible, should be given effect; courts avoid statutory interpretations that would render a provision superfluous.²² On the one hand, this rule of statutory construction provides further support for the conclusion that the NAIC-prescribed method must be used. Otherwise, the requirement in I.R.C. § 807(d) to use the NAIC-prescribed method is ignored. On the other hand, by applying this statutory construction principle, the conclusion of Notice 2010-29 possibly could be defended by saying that the IRS is deferring to the NAIC-prescribed AG 43, but only to the extent of the net premium reserve portion (the Standard Scenario Amount) in order to give meaningful effect to the other required tax reserve adjustments that contemplate a deterministic net premium reserve calculation. The problem with relying on this rationale is that the Standard Scenario Amount, standing alone, simply is not the method prescribed by the NAIC in the SVL; in many situations the Standard Scenario Amount is not an adequate reserve and does not satisfy any reasonable interpretation of the SVL definition of CARVM, which is the tax reserve method required by I.R.C. § 807.

GIVING EFFECT TO THE REQUIRED I.R.C. § 807(d) ADJUSTMENTS

As indicated above, the computation of federally prescribed reserves starts with statutory reserves and makes certain adjustments for the tax reserve method, interest and mortality or morbidity. The principle of statutory construction that disfavors interpretations that render statutory provisions to be superfluous would seem to suggest that some operative effect should be given to these tax reserve adjustments even in the context of an NAIC-prescribed method that includes a stochastic component, at least to the extent they are relevant and appropriate in implementing the method. But, this principle only applies to the required tax reserve adjustments. Because the Code does not address other assumptions, such as those related to policyholder behavior and prudent estimates, no adjustments to statutory reserves should be made for these assumptions in computing federally prescribed reserves.²³

The difficult interpretative issues that need to be addressed involve implementation of the requirements to “use” the discount rates and mortality tables prescribed by I.R.C. § 807(d). As explained below, it is questionable whether the I.R.C. § 807(d) adjustment for the discount rate is required to be made for stochastic reserves computed in a manner similar to the CTE Amount or PBR. But, if it is determined an adjustment is required, there are several ways this could be accomplished, some of which were offered as possibilities, without elaboration, in Notice 2008-

18. The inclusion of this issue in the IRS’ 2015–2016 Priority Guidance Plan provides an excellent opportunity for the IRS to work with insurance industry representatives and the actuarial profession to develop an approach that is administrable and integrates the I.R.C. § 807(d) tax reserve adjustments into the NAIC-prescribed method in a reasonable manner. There are at least three general approaches that could be considered, which for simplicity are discussed below in the context of AG 43. There are parallel concepts used in PBR and VM-20 with somewhat different terminology (net premium reserves, deterministic reserves and stochastic reserves).

Option 1. One option is a simple two-step approach. The first step would be to make all the adjustments required by I.R.C. § 807 to the net premium components of AG 43 and then, in the second step, add to that reduced net premium reserve the amount of the excess of the statutory stochastic component over the statutory net premium component. The result would take into account all the adjustments required by I.R.C. § 807 and would result in an appropriate tax/statutory reserve differential. An example of Option 1 is provided below.

The legal argument for this approach is based on the fact that I.R.C. § 807(d) provides that the federally prescribed reserve should be computed “using” the greater of the AFIR or the prevailing state assumed interest rate as well as the prevailing commissioners’ standard table, but the statute does not specify how the interest assumption is to be used. Because federally prescribed reserves are determined by the NAIC-prescribed reserve method, it follows that the interest and mortality assumptions must be “used” under I.R.C. § 807(d) in a manner consistent with that method. For stochastic reserves the NAIC-prescribed method requires discount rates that are market-based and regularly updated to achieve a more accurate statutory reserve level. It is reasonable to conclude that imposition of a fixed discount rate assumption in stochastic reserves is incompatible with the tax reserve method and, to avoid doing violence to the method and to avoid an inappropriate tax reserve level, should not be substituted for the discount rates in the stochastic component of reserves. That is, fixed assumptions for interest should be used in the NAIC-prescribed method only in those instances where the tax reserve method based on the NAIC-prescribed method specifies a comparable assumption locked-in at contract issuance.

The nature of the discount rates in stochastic reserves provides further support for limiting the discount rate adjustment to the net premium reserve component of AG 43. In theory, the discount rate in life insurance reserves is “used” as an estimate of the earnings rate on assets held to support the reserve reduced by the spread element for corporate profits and investment expenses. Because the discount rates in the stochastic component of AG 43 are directly tied to the actual anticipated asset-earnings rates in each scenario and expenses are considered elsewhere in the

computation, the NAIC-prescribed method uses the proper discount rate in the stochastic component of the reserve without the need for a further I.R.C. § 807(d) adjustment.

It also is reasonable to conclude that the mortality assumptions required by the NAIC for use in the stochastic component of reserves are “prevailing commissioners’ standard tables” that are acceptable for computing federally prescribed reserves. There is nothing in the Code that requires a contract to have a single prevailing commissioners’ standard table; to the contrary, I.R.C. § 807(d)(5) refers to “tables” for the contract—plural. Moreover, the statute does not preclude the use of company-specific factors in developing mortality tables and having the resulting tables treated as prevailing.²⁴ It has been settled law since 1942 that “recognized” mortality and morbidity tables for life insurance reserve qualification under what is now I.R.C. § 816(b) include tables accepted by insurance regulators that are constructed from a single company’s actual experience.²⁵ This rule for determining life insurance reserve qualification can reasonably apply by analogy to determine the prevailing commissioners’ standard tables for the contract for purposes of computing the amount of life insurance reserves.

Even if it were to be concluded that there are no prevailing commissioners’ standard tables for the stochastic portion of the reserve, I.R.C. § 807(d)(5)(C) provides in these circumstances that tables are to be prescribed by Treasury in regulations. Treasury could adopt the Option 1 approach by issuing regulations prescribing the use of the mortality assumptions in the stochastic reserves as the tax reserve tables. In the absence of regulations or IRS guidance, it would seem reasonable for companies to adopt this Option 1 approach.

It could be argued that if a discount rate and/or mortality adjustment is required only for the deterministic portion of an NAIC-prescribed reserve, the AG 43 method requires that the federally prescribed reserve be equal to the tax-adjusted Standard Scenario Amount plus the excess of the unadjusted CTE Amount over the tax-adjusted Standard Scenario Amount—in other words, the federally prescribed reserve ends up being equal to the entire statutory reserve allocable to the contract. Although this approach may follow from the legal arguments summarized above, and could be considered to yield a reasonable tax reserve amount consistent with Congress’ objectives in enacting I.R.C. § 807(d), the Option 1 approach described above also represents a reasonable way to address the IRS’ concerns expressed in Notice 2008-18.

Option 2. A second possible approach to I.R.C. § 807(d) compliance would be to make the interest and mortality adjustments to both the net premium reserve component as well as the stochastic reserve component of AG 43 and then follow the reserve methodology taking the greatest of the tax-adjusted re-



serve components as the federally prescribed reserve. Doing this would require a redetermination of both components, and with respect to the stochastic component of AG 43, alternative assumptions may need to be considered. For the mortality assumptions, it may be appropriate to substitute the prevailing table used in the net premium reserve in each scenario if the IRS does not permit the mortality assumptions in stochastic reserves to be treated as prevailing tables. A similar scenario-by-scenario substitution of discount rate assumptions required by I.R.C. § 807(d) would be difficult to implement, however, if the AFIR and prevailing state assumed interest rate are interpreted to require a contract-by-contract computation as of the time of contract issuance. The same problem likely would arise in this interpretation of I.R.C. § 807(d) in situations where there are multiple prevailing mortality tables in the net premium reserve calculations.

A possible approach to address this problem could be to make an aggregate adjustment to the stochastic portion of the reserves for the I.R.C. § 807(d) discount rate and the mortality assumptions. Perhaps a discount rate adjustment could be determined by first estimating a weighted average of the various discount rates used in the stochastic scenarios and then comparing that average rate to a weighted average of the discount rates used in the net premium reserve component as recomputed for tax purposes. If the average statutory discount rate in the stochastic reserve component is lower than the average discount rate used in the tax-adjusted net premium reserve component, an agree-

gate adjustment could be made. A similar approach could be used for the mortality table adjustment required by I.R.C. § 807(d). The goal under this approach is to develop a way to make an aggregate adjustment for the discount rate and/or the mortality table that is reasonably administrable and consistent with the overall NAIC-prescribed method. If it is determined that a discount rate adjustment is required for the stochastic component of reserves, actuarial work is needed to implement this option in the best way and to prevent duplicative aggregate interest and mortality adjustments. A preliminary reaction from several actuaries expressed to this author is that it may be unduly burdensome, and not readily auditable by the IRS, to adopt the approach in Option 2 and determine weighted average discount rates.

Option 3. A simpler method may be preferable if it is determined that a discount rate adjustment to the stochastic reserve component of AG 43 is required by I.R.C. § 807(d). A less burdensome option could be to rely directly on the NAIC-prescribed method's contract-by-contract statutory reserve allocations. For non-tax reasons, it is necessary for the NAIC to adopt a method by which the aggregate statutory reserve is allocated to individual contracts. This is because in the event of insolvency and liquidation of the company, the starting place for distribution of insufficient assets to each policyholder is the statutory reserve for each contract. For this reason, Appendix 6 of AG 43 has specific rules for allocation of statutory reserves to the contract level.

Under this third approach, the starting place for the I.R.C. § 807(d) adjustments would be the allocated contract-level statutory reserve. For example, under A6.2) of AG 43, when the aggregate reserve is equal to the Standard Scenario Amount, the discount and mortality tax adjustments simply would be made to each contract's separately computed Standard Scenario Amount without consideration of the CTE Amount. When the aggregate reserve is equal to the CTE Amount, the general approach of A6.1) of AG 43 could be followed using the Standard Scenario Amount instead of the cash surrender value as the base. First, the contract's Standard Scenario Amount would be recomputed making the appropriate tax adjustments. Then, a ratio of the tax-to-statutory Standard Scenario Amount would be computed. Next, the amount of excess of the contract's statutory reserves over the contract's statutory Standard Scenario Amount would be multiplied by the tax-to-statutory ratio of the Standard Scenario Amount. The final tax reserve would be the contract's tax-adjusted Standard Scenario Amount plus the tax-adjusted excess.

The following simple example of three annuity policies shows how Option 1 and Option 3 would operate for AG 43.

Aggregate Statutory Stochastic Resv
1100



NAIC allocation method

Policy #	Allocated Stat Resv
A	545
B	325
C	230

Option 1

(a)	(b)	(c)	(a) + (c) - (b)
SSA After I.R.C. § 807 Adjustments	Statutory SSA	Statutory CTE Amount	Final Tax Resv
500	525	545	520
290	310	325	305
200	220	230	210

Option 3

(d)	(e) = (d) - (b)	(f) = (e) × $\frac{"(a)"}{"(b)"}$	(a) + (f)
Allocated Stat Resv	Allocated Stat Resv less SSA	Tax Adjusted Excess	Final Tax Resv
545	20	19	519
325	15	14	304
230	10	9	209

As demonstrated by this example, because Option 3 would require an adjustment to the statutory reserve excess of the stochastic reserve over the net premium reserve component, it generally would result in smaller tax reserves than Option 1. The Option 2 approach could result in smaller or larger tax reserves as compared to either Option 1 or 3 depending on the level of discount rates used in the stochastic reserve and the amount by which the stochastic reserve exceeds the net premium reserve component. For example, in the case of AG 43, if the CTE Amount exceeds the Standard Scenario Amount and the implicit weighted average interest rate in the CTE Amount exceeds the weighted average AFIR, any tax adjustment to statutory reserves under Option 2 likely would be attributable to the mortality assumption and may be relatively small as compared to the tax adjustments in Options 1 and 3. For this reason, this author hopes that the IRS will have an incentive not to adopt the more burdensome and difficult-to-audit Option 2 as the preferred

method of implementing the tax adjustments required by I.R.C. § 807(d) for AG 43.

Whatever method is used to implement I.R.C. § 807(d)(2), the final step in the tax reserve computation—the comparison of the federally prescribed reserve to the cash surrender value and statutory reserves on a contract-by-contract basis—should be straightforward. The methods of allocation of the total statutory reserve to specific contracts in AG 43 and PBR can, and should, be applied for tax purposes.

ARE STOCHASTIC RESERVES INSURANCE RESERVES?

Notice 2008-18 expresses several issues that need to be addressed in the IRS' consideration of the 2015–2016 Priority Business Plan project. First, the Notice questions whether some portion, or even all, of the stochastic components of AG 43 and PBR are not really insurance reserves. The Notice asks whether stochastic reserves are nondeductible “solvency” or “contingency” reserves because they “would not represent an expected value of a company's obligations with respect to the underlying contracts.” Although not specifically in the Notice, IRS personnel have noted informally that consideration of an individual company's assets and expenses in the reserve calculation may lend support to the view that at least a portion of the stochastic reserves could be viewed as “asset adequacy reserves” or reserves for expenses that are not deductible.²⁶

Consideration of the nature of the stochastic reserve components of AG 43 and PBR should alleviate these concerns. An insurance reserve generally is computed as the present value of future benefits less the present value of future funding sources for those benefits. Historically, net premium reserves have been the industry norm for this computation and the assumptions used to determine the present value of future benefits and future funding sources have been fixed at issue and based on industry-wide data. Advancements in technology and computing capabilities have made it possible for reserves to more accurately reflect future liabilities, by analysis of multiple scenarios in varying economic conditions and company-specific facts. Stochastic reserves, in concept, are still determined in the same way as net premium reserves—as the present value of future benefits less the present value of the funding sources for those benefits. They merely take into account many potential cash flows on an aggregate basis using more available information. The computational differences from net premium reserves, however, do not make stochastic reserves anything other than insurance reserves. In fact, they are intended to achieve the same purpose—an appropriate measurement of the company's contractual liabilities.

To better see why this is the correct conclusion, it is useful to examine specific elements of stochastic reserves to compare the treatment of these elements with their treatment in traditional net premium reserves.

PROVISION FOR MODERATELY ADVERSE CONDITIONS

Stochastic reserves are not distinguishable from net premium reserves simply because the former contains “prudent estimates.” NAIC-prescribed net premium reserve methods generally take into account prudent estimates in several ways. The most obvious is in the standard mortality and morbidity tables, which typically are developed using industry-wide data and then “loaded” by an adjustment to ensure that the resulting assumptions will be sufficient to cover moderately adverse mortality and morbidity. By deferring to the commissioners' standard tables in computing federally prescribed reserves, I.R.C. § 807(d) recognizes that tax reserves should contain the tables' provisions for possible adverse experience.

The NAIC-prescribed reserve method itself also reflects a need to hold a prudent estimate level of reserves in an amount necessary for moderately adverse conditions. For example, CARVM requires that the greatest of the present values of the various possible benefit scenarios be used as the prescribed reserve. It does not permit a lower reserve equal to a weighted average of all future scenarios or a reserve equal to the most likely scenario. Similarly, CRVM currently does not permit a lapse assumption even though taking lapse rates into account could lower reserves.

This author has been told by life, property/casualty and health valuation actuaries who are responsible for a wide variety of products that the goal is generally the same across the board for contract and claim reserves—statutory reserves should be established at a level such that they will be sufficient in moderately adverse conditions. To satisfy this standard, a rule-of-thumb confidence level for reserve adequacy used by many actuaries is a confidence level in the 75 to 85 percent range. Is this conservatism in the reserve method? Not really; it is recognition that insurance reserves need to be adequate.

Stochastic reserves are not distinguishable from net premium reserves simply because the former contains “prudent estimates.” NAIC-prescribed net premium reserve methods generally take into account prudent estimates in several ways.



Several important conclusions can be reached from these observations. First, a provision for moderately adverse conditions is consistent with, and in fact generally required for, insurance reserves. Second, inclusion of “prudent estimates” in reserves does not mean that a portion of the reserve is for something other than the expected value of the company’s obligations. Third, the tax law has always incorporated this insurance reserve standard in determining the amount of deductible reserves. Fourth, it is inappropriate to suggest that an NAIC-prescribed reserve method is not an insurance reserve, or a portion is a “surplus” or “contingency” reserve, simply because the method unbundles the provision for moderately adverse conditions in the interest of greater transparency and accuracy. The objective is the same as for net premium reserves—to hold an appropriate level of reserves for the contractual benefits. Finally, there is a distinction between an insurance reserve estimated on the basis of prudent estimates and a “surplus” reserve reflected in the balance sheet, for example, to satisfy minimum risk-based capital objectives.

CONSIDERATION OF ASSETS AND EXPENSES

Because a company’s assets and expenses are not explicitly reflected in net premium reserves, questions have been raised as to whether, by taking into account assets and expenses in stochastic reserves, some portion of the reserves is a so-called “asset adequacy reserve,” a reserve for expenses or a deficiency reserve, which may not be a deductible insurance reserve. These questions reflect a misunderstanding of the role of the assumptions

relating to assets and expenses in the stochastic components of AG 43 and PBR.

At the outset, it is useful to dispel the notion that net premium reserves do not consider assets and expenses; they do. Net premium reserves consider assets implicitly by making two assumptions. The first assumption is that, once the reserve amount is determined, assets having a book value equal to the reserves will be available and sufficient to fund the contractual benefits when they become due. The second assumption is that the discount rate used to compute the reserve is a reasonable estimate of the earnings rate on the assets backing the reserve (net of the profit element and investment expenses). If the appointed actuary determines that these assumptions, which are hard-wired into the net premium reserve calculation, do not yield a sufficient aggregate level of reserves for the company as a whole, it may be necessary to hold an additional liability for the asset inadequacy. The need for an additional reserve in these circumstances is not because the assets themselves are inadequate in some way; it is because the assumptions in the reserve calculation as to the sufficiency of those assets and yield on those assets are imprecise.

Contract administration expense assumptions also are taken into account in a net premium reserve method; this is what the “net” means. As noted above, an insurance reserve is generally defined as the present value of future benefits less the present value of future premiums (or, more broadly, the present value of future funding sources for the benefits). If gross premiums were considered in this reserve computation without any consideration of administration expenses and profits, the reserve would be lower because the subtractive item for the present value of future premiums would be greater. The formula adjusts for this result by substituting only the value of future net premiums—gross premiums less the loading element that takes into account an assumed provision for expenses and profit in future considerations that are available to fund future liabilities.

This implicit consideration of expenses in a net premium calculation usually has the effect of increasing the level of reserves. Of course, due to many assumptions in the net premium method, it sometimes occurs that the assumed hypothetical future net premiums exceed the future actual gross premiums, which leads to the need for a deficiency reserve. As in the case of an asset adequacy reserve, the need for a deficiency reserve is not usually due to the fact that future gross premiums are actually inadequate to fund the contractual benefits; rather, it is a result of the fact that the assumptions in the net premium reserve calculation are not accurate.

Now, let’s examine how assets and expenses are considered in the stochastic components of AG 43 and PBR. Oversimplifying, what is happening is that the reserve assumptions for assets and expenses are based on many possible, reasonable assumptions rather than one-size-fits-all implicit assumptions. The scenari-

os in the stochastic analysis attempt to model recoverable asset values, net investment returns on asset and expenses using real-world, company-specific assumptions. In essence, the scenarios are projected using assumptions taking into account expected actual loading amounts for future expenses. Moreover, because actual expected cash flows are considered, once the calculation is made, a stand-alone asset adequacy reserve for the block of business is less of a consideration—realistic returns on assets for purposes of determining an appropriate level of statutory reserves is considered in the calculation. That is not to say that cash flow testing for the company as a whole does not have to be performed or that the stochastic reserve may satisfy cash flow testing standards; it only means that it is less likely that the AG 43 or PBR block will be the source of any asset inadequacy. Similarly, deficiency reserves are not relevant because assumptions are set at a level reflecting up-to-date experience, which allows the calculation to arrive at a more accurate “net” premium. Further, no portion of the reserve is properly viewed as a reserve for expenses. Taking into account expenses has the effect of decreasing the gross premium component of the future cash flows, just as they do implicitly in a net premium reserve.

To argue that a portion of the stochastic components of AG 43 and PBR reserves should be excluded from the federally prescribed reserves, because they are deemed to contain disguised asset adequacy reserves, reserves for expenses or deficiency reserves, is another way of saying that Congress intended that tax reserves be forever computed using antiquated, inaccurate assumptions regardless of the evolution of insurance products, actuarial practice and NAIC reserve requirements. Fortunately, this is not what Congress did when it enacted I.R.C. § 807(d) and deferred to the NAIC to fashion, and to update when necessary, the most appropriate reserve methodology for both regulatory and tax purposes.

CONCLUSION

Since Notice 2010-29 was issued, the IRS National Office has been focusing its attention on whether the CTE Amount in AG 43 should be included in statutory reserves under I.R.C. § 807(d) (6) for purposes of the statutory reserves cap on tax reserves. In the aftermath of the *American Financial* case, and the Supreme Court’s repeated admonition to lower courts and administrative agencies to adhere to the plain language of the statute, it is hoped that the IRS will expand its consideration to the role of stochastic reserves in the federally prescribed reserve. Absent guidance from the IRS, taxpayers will be forced to devise their own approaches to implementing I.R.C. § 807(d) for stochastic reserves, which are likely to be upheld if they are reasonable and consistently applied. It would be far better for the IRS to work together with the insurance industry to come up with an approach that makes sense and complies with Congress’ mandate to use the NAIC-prescribed method for tax reserves. ■

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END NOTES

- ¹ 2015-15 I.R.B. 547.
- ² For a detailed discussion of Notice 2010-29, see Peter H. Winslow and Christian Des-Rochers, *Attorney-Actuary Dialogue on Notice 2010-29*, Society of Actuaries *TAXING TIMES*, Vol. 6, Issue 3 (September 2010).
- ³ *American Financial Group v. United States*, 678 F.3d 422 (6th Cir. 2012); *State Farm Mutual Auto. Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012); *Acuity v. Commissioner*, T.C. Memo 2013-209.
- ⁴ I.R.C. § 807(d)(6).
- ⁵ Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 599 (1984).
- ⁶ This article discusses only the stochastic component of PBR and leaves for another day consideration of the deterministic gross premium reserve component.
- ⁷ 2008-1 C.B. 363.
- ⁸ *E.g.*, *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989); *The Limited, Inc. v. Commissioner*, 286 F.3d 324, 332 (6th Cir. 2002).
- ⁹ *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015).
- ¹⁰ *American Financial Group v. United States*, 678 F.3d 422 (6th Cir. 2012).
- ¹¹ *State Farm Mutual Auto. Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012); *Acuity v. Commissioner*, T.C. Memo 2013-209.
- ¹² I.R.C. § 832(b)(1), (b)(3); § 846(b), (f).
- ¹³ *Acuity v. Commissioner*, T.C. Memo 2013-209 (citing *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992)).
- ¹⁴ *Skidmore v. Swift*, 323 U.S. 134 (1944).
- ¹⁵ *United States v. Mead Corp.*, 533 U.S. 218 (2001).
- ¹⁶ H.R. Rep. No. 98-432, pt. 2, at 599-600 (1984).
- ¹⁷ *E.g.*, I.R.C. § 807(d)(2)(C) permitting adjustments to tables for nonstandard risks.
- ¹⁸ H.R. Rep. No. 98-861, at 1051 (1984) (Conf. Rep.); S. Prt. 98-169, at 540 (1984).
- ¹⁹ Rev. Rul. 71-544, 1971-2 C.B. 227.
- ²⁰ *United States v. Cambridge Loan & Building Co.*, 278 U.S. 55 (1928).
- ²¹ H.R. Rep. No. 98-861, at 1052 (1984) (Conf. Rep.).
- ²² *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 217 (2001).
- ²³ Representatives of the IRS have sometimes argued that company-specific assumptions based on actuarial discretion are not permitted in federally prescribed reserves. As indicated above, there is no support for this contention in the statute or legislative history. Similarly, arguments have been made that federally prescribed reserves should be adjusted to eliminate prudent estimates. This argument is addressed later in this article. Also, for the reasons discussed below, the concepts of nondeductible deficiency reserves, a reserve for expenses, or an adjustment for deferred and uncollected premiums are not relevant for the stochastic portion of the reserves.
- ²⁴ As indicated earlier in the article, the legislative history sometimes relied on to suggest that Congress intended companies to obtain the same reserve deduction for similar products regardless of company-specific experience does not, in fact, support this assertion.
- ²⁵ S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942).
- ²⁶ Treas. Reg. § 1.801-4(e)(5).

Tax Contours of Insurance Refined: *RVI v. Commissioner*

By Jean Baxley and Sheryl Flum

In September 2015, the Tax Court issued its opinion blessing residual value insurance¹ contracts as “insurance” for federal income tax purposes.² The contracts at issue in the case cover lessors and lenders against the risk that the actual residual value of an asset, i.e., its value when returned at the end of the lease period, will be significantly lower than the expected residual value of the asset at the outset of the lease. The *RVI* decision signals the Tax Court’s willingness to acknowledge that nontraditional lines of coverage can pass muster as insurance for tax purposes.

This article provides a brief backdrop to the “what is insurance” issue, summarizes the Tax Court’s opinion in *RVI*, and offers observations regarding some of the potential implications of the decision.

THE “DEFINITION” OF INSURANCE

In the tax context, the Internal Revenue Code (“Code”) and Treasury regulations don’t define insurance. This lack of a tax-tailored definition of “insurance” may be appropriate given that insurance products are constantly evolving and are generally subject to state (and sometimes federal, e.g., Securities and Exchange Commission (SEC)) regulatory oversight.³ Whether a contract constitutes insurance affects, among other things, whether the insurance company can carry insurance reserves, whether the insured can deduct the premium paid for coverage (e.g., for business property-casualty covers), and whether inside buildup (e.g., life insurance cash values) can grow free of current taxation.

In the life context, Code section 7702 provides a detailed test for qualification as a life insurance contract. There are no such tax-specific guidelines for non-life insurance products.

There are plenty of litigated cases and numerous Internal Revenue Service (IRS) revenue rulings, technical advice memoranda (TAMs), and other guidance that address the topic of what constitutes insurance. But as product offerings change, it is difficult for insurance companies and the IRS to keep up with a working definition of “insurance.” Ultimately, the question of whether a certain product or contract constitutes insurance for tax purposes is a fact-intensive inquiry that does not easily lend itself to bright-line tests and precise definitions. Over time, the contours of a common law tax “test” for what constitutes insurance have

emerged, which broadly speaking involves one form or another of these factors: presence of insurance risk; risk shifting or risk transfer from insured to insurer; risk distribution (insurer pools and spreads many independent risks); and insurance in its “commonly accepted” sense.

THE FACTS IN *RVI*

During 2006, the tax year at issue, R.V.I. Guaranty Co. Ltd (“RVIG”) was a Bermuda-domiciled insurance company that had in effect an election under section 953(d) to be taxed as a U.S. insurance company for federal income tax purposes. RVIG was regulated as an insurance company. RVIG’s subsidiary, RVI Insurance Company of America (“RVIA”) was a U.S. property-casualty insurance company. RVIA was licensed and regulated in, and sold policies in, seven states. RVIA and RVIG file a consolidated federal income tax return on Form 1120-PC, with RVIG as the parent company.⁴

RVIA’s business consisted solely of issuing residual value insurance policies (the “RVI Policies”) to customers. RVIA’s customers were property leasing companies, manufacturers and financial institutions that financed leases of the covered real and personal property. RVIA was not the only insurance carrier issuing this type of coverage; other major carriers also issued residual value coverage. But unlike these other major carriers, RVIA was a monoline issuer. RVIA ceded to RVIG most of its risk on the RVI Policies.⁵

The RVI Policies protect the insured from a greater than expected decline in the value of the covered leased assets, i.e., the risk that a covered leased asset’s value when returned at the end of the lease period will be significantly lower than the expected residual value that was determined at the outset of the lease. The amount insured under an RVI Policy is the difference between the actual value of the insured asset at the end of the lease and the insured value. The insured value is set below the expected residual value, i.e., the insured retains some of the risk on the difference between the actual and expected residual value. The expected residual values for covered assets were determined taking into account regular wear and tear.

At lease termination, RVIA determines whether a loss has occurred with respect to the covered leased property and, if so, the amount of the covered loss.

RVIA wrote three types of policies: (1) FASB policies, which were designed with insured value levels just high enough to allow the lessor to apply direct financing lease accounting under SFAS 13; (2) primary policies, for which the insured value is not tied to lease accounting; and (3) hybrid policies, under which each asset is covered by both FASB and primary coverage. Pricing for coverage under an RVI Policy ranged from 50 cents per \$100 to \$4 per \$100 of insurance protection. The customer

typically paid a single upfront premium for coverage. Some, but not all, of the RVI Policies involved a deductible to be paid by the insured.

The properties covered by the RVI Policies represented three business segments: (1) commercial real estate (including 15 types of properties, e.g., retail stores, warehouses, motels), (2) passenger vehicles (including 20 types of automobiles, e.g., pick-up trucks, sedans, SUVs), and (3) commercial equipment (including aircraft, industrial equipment and rail cars). Each segment represented approximately one-third of RVIA's business, as measured by relative unearned premium at 2006 year-end. Lease terms of the covered properties ranged from one to five years (for vehicles) to up to 28 years (for real estate).⁶

RVIA treated the RVI Policies as insurance for statutory accounting purposes under Statement of Statutory Accounting Principles 62R ("SSAP 62R"), which requires that the insurer assumes significant risk and has a reasonable possibility of a significant loss from the insurance that it issues.⁷

RVIA's annual loss ratio (paid losses (including loss adjustment expenses) to earned premium) for 2006 was 33.2 percent; its cumulative loss ratio from 2000 through 2006 was 27.7 percent; its cumulative loss ratio from 2000 through 2013 was 34 percent.

The IRS challenged the insurance status of the RVI Policies for tax purposes based principally on the assertion that the insured lessors and lenders who purchased the RVI Policies were purchasing protection against an "investment" risk rather than an insurance risk—although during briefing and the trial the IRS also argued that the RVI Policies failed other prongs of the common law test for insurance.⁸ Based on its investment risk theory, the IRS concluded that RVIA and RVIG were not insurance companies for tax purposes and assessed an income tax deficiency of approximately \$55 million for the 2006 tax year.

THE TAX COURT'S ANALYSIS

The Tax Court, in its opinion, identifies the characteristics of insurance as (1) risk shifting, (2) risk distribution, (3) commonly accepted notions of insurance, and (4) the presence of insurance risk; discusses each characteristic; and concludes that the RVI Policies constitute "insurance" for federal income tax purposes. These four characteristics are discussed in the order in which they are set forth in the opinion.

(1) Risk Shifting

The risk shifting prong of the insurance test is handled in fairly short order, with the court observing that "insurance must be examined from the perspective of both the insurer and the insured."⁹

Tax Court's risk shifting standard (paraphrased): The court concludes essentially that an arrangement involves risk transfer

from the insured's perspective if the insured externalizes its risk of financial loss by paying the insurer a premium. From the insurer's perspective, risk transfer has occurred if SSAP 62R is satisfied.

Outcome of Tax Court's analysis: Viewing the arrangement from both perspectives, the court has "no difficulty concluding" that a meaningful risk of loss was transferred from the lessors and finance companies that purchased the RVI Policies to RVIA.¹⁰ The court finds that the RVI Policies satisfy risk shifting because the lessors and lenders that purchased the RVI Policies transferred to RVIA (and, consequently, RVIG through reinsurance) a meaningful risk of loss. The court notes that without the residual value coverage provided by RVIA, the lessors and lenders would bear the entire risk of a substantial drop in a covered leased asset's value at the end of the lease term when the asset was returned to the lessor or lender.

Support for Tax Court's conclusion: The court notes that RVIA was "indisputably" well-capitalized and in a position to absorb risks and pay claims.¹¹ Emphasis is also placed on the fact that the RVI Policies were reported as insurance for statutory accounting purposes under SSAP 62R, which requires the insurer to assume a significant risk under the contract and face a reasonable possibility of incurring a significant loss. Furthermore, the court points out that the IRS' expert committed a methodological error by limiting his analysis of losses to years prior to and including 2006. Many of the RVI Policies had experienced no losses as of 2006—and could not have experienced such losses—solely because the applicable lease terms for the insured properties had not yet expired, i.e., it was too early to know whether there would be losses on these policies. In de-bunking the IRS expert's testimony, the court emphasizes that RVI's cumulative loss ratio through 2006 was 28 percent, and in subsequent years it increased to 34 percent, which indicated that RVIA had taken on significant risk of loss.

(2) Risk Distribution

The risk distribution prong of the insurance test is not discussed extensively in the opinion, and was not the crux of the disagreement between the IRS and RVIA. Indeed, one of the IRS' experts acknowledged that RVIA achieved pooling, diversification, and distribution of risk.

Tax Court's risk distribution standard (paraphrased): The court concludes that meaningful risk distribution is sufficient, stating that "perfect independence of risks is not required."¹² Noting that all insurers face systemic risk—e.g., economic downturns, high interest rates—the court concludes these systemic risks do not negate risk distribution.

Outcome of Tax Court's analysis: The court concludes that risk distribution is satisfied as RVIA took on a "vast array" of risk



exposures and distributed risk on the RVI Policies temporally, geographically, and across asset classes.¹³

Support for Tax Court's conclusion: The court notes that during 2006, RVIA had issued 951 policies to 714 insureds covering 754,532 vehicles, 2,097 real estate properties and 1,387,281 commercial equipment assets. The RVI Policies were distributed across three major business segments (i.e., passenger vehicle, commercial equipment, real estate), and further distributed across asset types within each segment, across geographic locations (for real estate), and across lease duration ("temporal distribution").¹⁴

The court emphasizes that systemic risk, such as major recession, is mitigated to some extent by the temporal distribution of RVIA's risks over varied lease terms.

(3) Insurance in Its "Commonly Accepted" Sense

The commonly accepted notions of insurance prong of the insurance test is discussed more extensively than either the risk shifting or risk distribution prong.

Tax Court's "commonly accepted sense" standard (verbatim): The court sets forth factors to consider to include "(1) whether the insurer is organized, operated, and regulated as an insurance company by the States in which it does business; (2) whether the insurer is adequately capitalized; (3) whether the insurance policies are valid and binding; (4) whether the premiums are reasonable in relation to the risk of loss; and (5) whether premiums are duly paid and loss claims are duly satisfied" (citing *Harper Group v. Commissioner* and *Securitas Holdings*).¹⁵

Outcome of Tax Court's analysis: The court finds that the RVI Policies constitute insurance within the commonly accepted sense because RVIA was organized, operated and regulated as an insurance company and the RVI Policies are treated as insurance for nontax purposes.

Support for Tax Court's conclusion: The court emphasizes that RVIA and RVIG were organized, operated and regulated as insurance companies in their respective domiciles. RVIA and RVIG met the minimum capital requirements of their respective regulators, and were adequately capitalized. State regulation is highly significant to the determination of insurance in its commonly accepted sense.

The RVI Policies were valid and binding. Insureds filed claims, and RVIA paid claims. Premiums charged were negotiated at arm's length. The RVI Policies were insurance in form and contained "standard provisions typical of insurance policies."¹⁶

The court characterizes the IRS' argument as amounting to an argument that the RVI Policies do not qualify as insurance because they "differ in certain respects from insurance policies with which most people are familiar."¹⁷ Whether a loss has occurred cannot be known until the associated lease ends, but the fact that loss determination and payment occurs at lease end "does not impugn [the RVI Policies'] status as 'insurance.'"¹⁸

Losses on the RVI Policies are caused by fortuitous events beyond the insured's control. The fact that there is a set date, i.e., the end of the lease term, for determining whether a loss has occurred doesn't change this. The characteristics and business needs of the underlying leasing transactions drive this timing. The court concludes that nonrefundable premiums do not change this result, as the lack of availability of a premium refund is designed to prevent an insured whose asset has very likely appreciated in value from opportunistically discontinuing coverage halfway through the term of the lease.

The RVI Policies are analogous to municipal bond insurance with respect to the timing of loss determinations, i.e., where bond interest due dates and maturity dates are known in advance, but this does not mean the loss-causing event occurs in a non-fortuitous way.

(4) Insurance Risk

Whether the RVI Policies cover insurance risk, as juxtaposed against investment risk, is at the heart of whether the RVI Policies constitute "insurance," and must be examined from the perspective of both the insurer and the insured. -

Tax Court's insurance risk standard (paraphrased): Regarding insurance risk, the crux of the court's analysis is that if a product has been treated as involving insurance risk by state insurance regulators and by an insurer's independent auditors, it can involve insurance risk even if it resembles an investment product in some respects.

Outcome of Tax Court's analysis: From RVIA's perspective, it was exposed to risk for significant underwriting losses; RVIA's

possible loss under an RVI Policy could vary from zero to the full insured value. Pricing risk does come into play, as premiums are rarely more than 4 percent of the insured value—but this is “the same pricing risk assumed by insurance companies generally.”¹⁹ From the insured’s perspective, the loss insured against is not an investment loss, but a business-related loss as the insured is in the business of leasing or financing assets.

The court was unpersuaded by the IRS’ argument that the RVI Policies are akin to put options on stock and, thus, are investment related rather than insurance related.

Support for Tax Court’s conclusion: RVIA is an insurance company licensed to conduct the business of insurance; it pays state premium taxes, and meets minimum solvency requirements.

For more than 80 years, states have regulated products that provide coverage against the decline in market values of particular assets as “insurance.” Certain states, e.g., New York and Connecticut, have by statute defined residual value policies as “insurance” for almost 30 years.

RVIA’s insurance regulators and independent auditors concluded that the RVI Policies involve insurance risk. State insurance regulators have “uniformly” concluded that the RVI Policies involve insurance risk.²⁰ RVIA’s independent auditors, along with the Connecticut Insurance Department, approved RVIA’s statutory financial statements, which treat the RVI Policies as transferring sufficient insurance risk to be treated as “insurance” under SSAP 62R.

The IRS expert’s argument that insurance must entail “pure risk,” i.e., a binary situation must exist whereby the only possible outcomes are “loss” or “no loss,” lacks practical and theoretical support. Certain other coverages, such as mortgage guaranty insurance and municipal bond insurance, do not involve such binary outcomes but still are (and have been, historically) respected as involving “insurance” risk. In asserting its “pure risk” theory, the IRS is “confusing the events that may trigger a payment obligation with the events that actually cause the loss.”²¹ So, for example, a homeowner’s default on a mortgage payment may or may not result in a loss, depending on whether the outstanding mortgage amount is greater than or less than the value of the mortgaged property.

The court was unpersuaded by the IRS’ argument that the RVI Policies entail mere investment risk and are akin to put options on stock. First, the court noted that “the insureds are not investors and the policies are not derivative products.”²² Indeed, the IRS agrees that the RVI Policies are not and cannot be taxable as derivative products; the policies were priced, sold and regulated as insurance products. Second, the court describes the assets that are covered by the RVI Policies as “ordinary business assets

in the nature of inventory or equipment.”²³ The insureds don’t acquire the assets to sell them and generate gain; indeed, the lessors’ business model takes into account the fact that the value of the assets likely will decrease over the duration of the lease. Third, put options are “typically settled for cash rather than by actual transfer of the underlying shares.”²⁴

RVIA’S CONTRIBUTIONS TO THE TAX DEFINITION OF “INSURANCE”

The decision in *RVI* provides substantial taxpayer-friendly language that can be relied upon in discussions with the IRS regarding non-“plain vanilla” insurance products, both in the life and nonlife context. The opinion doesn’t cover new ground in the risk shifting and risk distribution context, but significantly expands upon previous courts’ discussions of “insurance risk” and “commonly accepted” notions of insurance.

The main issue in the case was how to differentiate “insurance risk” from “investment risk.” The IRS has a history of challenging nontraditional forms of insurance coverage, especially when the product appears to be non-casualty-related, e.g., when there is a contract end date on which it is determined whether a loss has occurred and the extent of such loss, rather than a sudden casualty-type loss. *RVI* strongly rejects the IRS’ attempt to pigeonhole an unconventional, risk-based product, such as residual value insurance, into a “non-insurance” category and signals the Tax Court’s willingness to analyze the insurance features of each product individually.²⁵

The Tax Court relies heavily on the state regulatory treatment of the RVI Policies—especially since that treatment is longstanding. Form matters. One might even say the decision in *RVI* makes treatment as “insurance” versus an investment or financial product elective. For example, opportunities may exist to choose insurance characterization by issuing products in an insurance company that is regulated by the state, using insurance contractual terms rather than derivatives contractual terms, and characterizing a particular product as insurance under statutory accounting rules. The Tax Court’s reliance on state regulatory treatment and statutory accounting may provide support for such reliance in other contexts and for other types of products or product innovations.

In rejecting the IRS’ “pure risk” theory, the Tax Court implicitly acknowledged there can be gradations of insurance coverage and varying levels of losses and self-insurance. The court’s refusal to endorse a binary model of risk continues the facts-and-circumstances-based flavor of the “insurance” inquiry for federal income tax purposes—which provides opportunities as well as introduces potential pitfalls. In light of the Tax Court’s sound rejection of this theory in *RVI*, it would be a bit surprising if the IRS were to re-assert the theory in other cases.

In rejecting the IRS' analogy to put options on stock, the Tax Court introduced a newly relevant concept: insurance protects against losses on regular business assets. As pointed out in the opinion, the lessors that purchased the RVI Policies did not expect the covered assets to appreciate; they expected the assets to decline in value and purchased the RVI Policies to protect themselves from large business losses. Lack of potential upside in an arrangement may tend to support insurance characterization over investment characterization.

Overall, *RVI* refines the contours of the insurance risk and "commonly accepted" prongs of the "insurance" test for federal income tax purposes. It is unlikely, however, that a bright-line test defining "insurance" will emerge—and perhaps that works out best in the long run both for taxpayers and the IRS: Taxpayers can continue product innovation and take positions regarding insurance versus non-insurance status, and the IRS can challenge arrangements it views as abusive. ■

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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END NOTES

- ¹ The use of the term "insurance" does not automatically mean the product qualifies as insurance for federal income tax purposes.
- ² *R.V.I. Guaranty Co. Ltd. v. Commissioner*, 145 T.C. No. 9 (Sept. 21, 2015).
- ³ Having tax treatment as insurance conform to state regulatory treatment as insurance would be a simple, bright-line rule, but could at times be both under- and over-inclusive.
- ⁴ Accordingly the tax litigation was conducted in RVIG's name.
- ⁵ RVIG also reinsured a small amount of business written by third-party carriers; this third-party reinsurance represented less than one percent of RVIG's business in 2006.
- ⁶ Some of the RVI Policies used a pooling methodology under which multiple assets with lease termination dates within a specified period were covered under a single policy, and the determination of a loss on the policy was made on an aggregate basis, i.e., a loss on a pooled policy occurred if the aggregate value of the pooled assets at lease-end was less than the aggregate insured value of the pooled assets.
- ⁷ For GAAP purposes, RVIA treated the RVI Policies as derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998) and EITF No. 01-12, *The Impact of the Requirements of FASB Statement No. 133 on Residual Value Guarantees in Connection with a Lease* (2002) when the residual value was determined based on the higher of the actual sales price of the property or the value set forth in a specified guidebook (e.g., the "Blue Book" value for automobiles).
- ⁸ This challenge was not unexpected, as the IRS Office of Chief Counsel had issued TAM 201149021 (Dec. 9, 2011), taking the position that residual value insurance contracts were not "insurance" for federal income tax purposes. See Baxley, Juran, Chen, Pichette, *Residual Value Contracts Fall Outside the (Fuzzy) Line*, 21 BNA DTR 1, J-1 (Feb. 2, 2012).
- ⁹ Slip Op. 27.
- ¹⁰ Slip Op. 28.
- ¹¹ Slip Op. 28.
- ¹² Slip Op. 35.
- ¹³ Slip Op. 32.
- ¹⁴ Slip Op. 35.
- ¹⁵ Slip Op. 36–37.
- ¹⁶ Slip Op. 38.
- ¹⁷ Slip Op. 38.
- ¹⁸ Slip Op. 39.
- ¹⁹ Slip Op. 45.
- ²⁰ Slip Op. 48.
- ²¹ Slip Op. 56.
- ²² Slip Op. 57.
- ²³ Slip Op. 57.
- ²⁴ Slip Op. 58.
- ²⁵ Note that the Tax Court declined to express a view regarding coverage for loss of earnings attributable to foreign currency fluctuations, which was found to not qualify as "insurance" in CCA 201511021 (March 13, 2015).



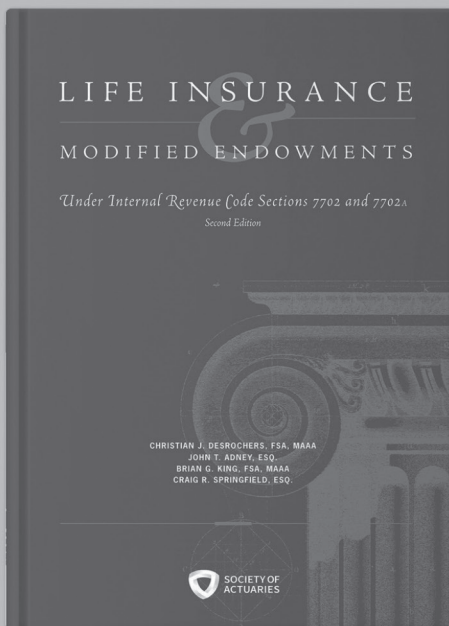
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Investor Control: Will You Know It When You See It?¹

By Ann Cammack and Frederic J. Gelfond²

Since the 1970s taxpayers purchasing and selling variable life insurance and annuity contracts have been wary of the “Investor Control Doctrine.” With the 1984 passage of the diversification requirements in section 817(h) of the Internal Revenue Code (the “Code”),³ and the issuance of the accompanying regulations in 1986, some have taken the position that the Investor Control Doctrine was subsumed by the diversification requirements. Others have suggested that the doctrine is unclear and would be difficult to sustain other than in extreme circumstances that would otherwise violate more established and judicially tested form-over-substance principles. The Internal Revenue Service (IRS), however, has continued to put taxpayers on notice that the Investor Control Doctrine retains its vitality even after enactment of the diversification requirements and continued judicial development of form-over-substance standards. For example, it has continued to issue guidance in the form of revenue rulings and to provide taxpayers private letter rulings.

On June 30, 2015, the U.S. Tax Court reaffirmed the viability of the Investor Control Doctrine in *Webber v. Commissioner*.⁴ The case serves as a valuable example of what not to do with regard to the investment of assets supporting a variable life insurance contract purchased through a private placement transaction. In the end, however, the *Webber* court leaves a lot of questions unanswered—most significantly, the elusive answer to how to define investor control. The case leaves taxpayers with a little less gray area but significant uncertainty about how to address arrangements that are, for example, not squarely within the facts of the safe harbor established in Rev. Rul. 2003-91,⁵ in which all investment decisions were made in the sole and absolute discretion of the company and its investment manager, but that are not clearly as egregious as the transaction at issue in *Webber*. While it does not provide all the answers to what type of behavior will be respected, through its analysis, the decision provides a clarion call to those seeking to structure or enter into private placement variable contracts as to the facts that a court could consider to be relevant to analyzing the presence of inappropriate investor control.

This article examines the Investor Control Doctrine, as explained and applied by the U.S. Tax Court in *Webber*, and considers

some of the open questions that remain after June 30, 2015. In doing so, it points out the factors the court indicated taxpayers will continue to need to consider.

INVESTOR CONTROL DOCTRINE

From the standpoint of the contract holder, earnings on assets supporting life insurance and annuity contracts accrue on a tax-deferred basis. Simply stated, there is no tax to the contract holder until there is an actual or deemed distribution of those earnings. In the case of a life insurance contract, those earnings can effectively be fully excluded from taxable income if the only distribution under the contract is in the form of a death benefit. This deferral treatment is consistent with the concept of constructive receipt. The insurance company, and not the contract holder, owns the assets supporting the life insurance company's obligations under the contract. A contract holder has to give up valuable rights, including control over the assets supporting the contract, through premiums paid to purchase the contract. Similarly, the contract holder forfeits valuable assets when it receives distributions of the earnings under the contract, e.g., diminution of benefits under the contract or surrendering the rights to remain insured.

Looked at another way, a policyholder's only right under an insurance contract is to get paid under the terms of the contract. The insurance company can invest the premium dollars it receives in any manner it chooses, as long as it pays the policyholder in accordance with such terms. In the case of a variable contract, the fund or investment that serves as the basis upon which the policyholder is to be paid is merely an index. The insurance company is not obligated to actually make the subject investment. Thus, if a policyholder is able to direct the insurance company how to invest its premium dollars, it is exercising the dominion and control over the investing activity that is arguably the exclusive province of the insurance company.

The government faced these questions: What happens if the purchaser of the contract doesn't give up total control over the assets or is exercising extra-contractual dominion and control? Should the logic of constructive receipt continue to shield the earnings credited to the contract from tax before a distribution if the contract holder is exercising the rights of the owner of the assets, including making all the investment decisions concerning the assets? Moreover, what actions may a policyholder take before it will be deemed to be the owner of the assets? If the contract holder directs the purchase of particular assets, who truly maintains the valuable rights of asset ownership? The Investor Control Doctrine was developed by the government to address just these types of situations.

The “Investor Control” Doctrine has its roots in Supreme Court jurisprudence. In *Helvering v. Clifford*,⁶ the taxpayer contributed

securities to a trust and named himself as the trustee. The trust directed him, as trustee, to pay the income to his wife for five years. At the end of five years, the trust was to terminate and the corpus would revert to the taxpayer. The trust instrument authorized the taxpayer to vote the shares held by the trust and to decide what securities would be bought or sold. The trust instrument also afforded him “absolute discretion” to determine whether income should be reinvested rather than paid out. According to the Court, the taxpayer’s control over the securities remained essentially the same before and after the trust was created. As for the taxpayer’s “dominion and control” over the asset, the Court stated that “it seems clear that the trust did not effect any substantial change.”⁷ In the end, the Court concluded that, based on “all considerations and circumstances,” the taxpayer retained the attributes of an owner, and should be treated as the owner of the trust assets for federal tax purposes.⁸

In the 1970s, the IRS began facing situations in which contract holders were exercising significant control over the management and investment of assets supporting variable insurance contracts. Beginning in 1977, the IRS began issuing guidance on when a contract holder taxpayer exercises sufficient control over variable product assets that it would be appropriate to treat the contract holder, and not the insurance company, as the owner of the assets supporting the contract for federal tax purposes. The result of such treatment is that any earnings on such assets would be taxed currently—the benefit of deferral would be lost.

The first formal guidance setting forth the Investor Control Doctrine is Revenue Ruling 77-85. Rev. Rul. 77-85⁹ deals with an investment annuity contract issued by an insurance company and purchased by a taxpayer. The premium was deposited into a separate account held by a custodian. The policyholder had a power to sell, purchase, or exchange securities; to invest and reinvest principal and income; to vote the shares; to exercise option relating to assets; and to surrender the policy. The IRS, looking to the Supreme Court’s guidance in *Clifford*, concluded the taxpayer, not the insurance company, should be considered the owner of the assets, as he possessed significant incidents of ownership. Thus, any interest, dividends, and other income derived from securities held in the separate account should be includable in the gross income of the taxpayer.¹⁰

The IRS also addressed situations when separate accounts supporting variable contracts invest, not in securities selected directly by the policyholder, but in shares of mutual funds with their own investment manager. In Rev. Rul. 81-225,¹¹ the IRS concluded that the policyholder had sufficient investor control when the mutual fund shares were available for purchase by the general public wholly apart from the annuity arrangement. When investments in the mutual fund shares were controlled by the insurance company and the fund only functioned as an investment vehicle, however, the IRS concluded that the insurance

company was the owner of the assets because the shares were not available to the general public. Similarly, in Rev. Rul. 82-54, the IRS stated that the control over individual investment decisions must not be in the hands of the policyholders in order for the insurance company to be considered the owner of the mutual funds.¹³

Taxpayers challenged the Investor Control Doctrine and two courts considered whether the doctrine was valid and whether it had been properly applied by the IRS. In both cases, the IRS prevailed and the Investor Control Doctrine was sustained. In *Christoffersen v. United States*,¹⁴ a unanimous Eighth Circuit concluded that the owners of a variable annuity contract were the beneficial owners of the assets that supported the contract because the contract holders had “surrendered few of the rights of ownership or control over the assets in the sub-account.”¹⁵ According to the court, the fact that the assets were formally owned by the insurance company was not dispositive; rather, the court looked to “actual command” over the assets.¹⁶ The second case to address the validity of the investor control rules, *Inv. Annuity, Inc. v. Blumenthal*,¹⁷ was dismissed by the appellate court due to lack of jurisdiction. The trial court had concluded that Rev. Rul. 77-85 was invalid.

Congress entered the picture in 1984 with enactment of the investment diversification rules of Code section 817(h). That section establishes the minimum number of assets that may be held and percentage of ownership of those that must be satisfied for a variable life or annuity contract to be treated as such for federal income tax purposes. Regulations promulgated under section 817(h) provide guidance on how to meet these requirements and set forth look-through rules permitting taxpayers to look through a fund to the individual assets held by the account, if certain ownership limitations are met. Some practitioners have argued that section 817(h) supplants the Investor Control Doctrine but most disagree with this approach, and the IRS has continued to apply the Investor Control Doctrine, including issuing private letter rulings and other guidance to assist taxpayers as they review the application of these rules to their fact pattern.¹⁸

The IRS and Treasury continue to publish formal guidance on investor control. In Rev. Proc. 99-44,¹⁹ the government provided relief to certain annuities purchased in connection with sections 403(a), 403(b) or 408(b), stating that arrangements will not be disqualified merely because they are invested in publicly available funds. This ruling resolved some long-standing ambiguity about how the Investor Control Doctrine applies to certain qualified plans. Rev. Ruls. 2003-91 and 2003-92 provide detailed guidance on the application of the Investor Control Doctrine, setting out a safe harbor for taxpayers in Rev. Rul. 2003-91 and providing clarification on the application of the doctrine to certain partnerships in Rev. Rul. 2003-92.²⁰ Finally, in 2008, Treasury and the IRS issued Notice 2008-92,²¹ which

announced, among other things, that the IRS would not assert a violation of investor control against insurance-dedicated money market funds participating in Treasury's temporary guarantee program for money market funds.

In Rev. Rul. 2003-91, which was at issue in *Webber*, the IRS provided a "safe harbor" for taxpayers. The IRS concluded that the insurance company would be treated as the owner of the assets in the separate account provided the insurance company and its investment manager made all investment decisions regarding those assets. The policyholder could not select or recommend particular investments for the subaccounts; the policyholder could not communicate directly or indirectly with any investment officer; there could be no arrangement, plan, contract or agreement between the policyholder and the insurance company or investment manager regarding the investment strategy.²² Drawing on the *Clifford* decision, Rev. Rul. 2003-91 makes it clear that the determination of whether an arrangement involves investor control depends on all the facts and circumstances.

THE WEBBER CASE

A: The Entities

It is against the backdrop of this 40-year history that the *Webber* case arose. Jeffrey T. Webber was a venture-capital investor and private-equity fund manager. He founded and managed a series of private-equity partnerships that provided "seed capital" to startup companies. Separately, he provided consulting services to startup ventures through his own firm, which was usually the managing director or the general partner of venture-capital partnerships. Mr. Webber retained the authority to make investment decisions for the partnerships. He invested in and served on the boards of 24 companies at various times prior to Dec. 31, 2007.

Mr. Webber hired a personal accountant and an attorney for his estate planning. In 1999, the attorney suggested a tax-minimization strategy through the purchase of private placement life insurance policies from Lighthouse, a Cayman Islands life insurance company. The policies would be held in a grantor trust and the attorney and the Alaska Trust Co. would act as co-trustees, although Mr. Webber could remove or replace the trustees at any time. The trust beneficiaries included Mr. Webber's family, and Mr. Webber was named as a discretionary beneficiary. The trust purchased two flexible premium variable life insurance policies from Lighthouse.

At the request of Mr. Webber, the first trust was dissolved and all the assets were moved to a Bahamian grantor trust in 2003. The Bahamian grantor trust was listed as the nominal owner of the two policies until Mr. Webber decided to move the trust assets back to a domestic grantor trust. Thus, the Bahamian trust was the nominal owner of the policies in 2006 and 2007, the tax years

at issue. Mr. Webber was the grantor and treated as the owner of the Bahamian Trust for federal income tax purposes.

B: The Policies

The policies insured the lives of two of Mr. Webber's relatives: the stepgrandmother of Mr. Webber's then wife and his aunt. Each policy had a minimum guaranteed death benefit of \$2,720,000, which was payable in all events so long as the policy remained in force. Each policy required Lighthouse to establish a separate account pursuant to the Cayman Islands Insurance Law. Lighthouse transferred most of the mortality risk premium to Hannover Re. The parties agreed that the policies met the requirements of section 7702 and were modified endowment contracts (MECs) within the meaning of section 7702A.²³

The premium, less annual administrative and mortality charges, was allocated to separate accounts. If the assets in the separate account were insufficient to defray each year's mortality and administrative charges, the policyholder had to make an additional premium payment; otherwise, the policy would lapse. Upon the insured's death, the beneficiary would receive the greater of the minimum guaranteed death benefit or the value of the separate account. Also, the policies permitted the policyholder to add additional premiums if necessary, and the Alaska Trust made an additional premium payment of \$35,046 in 2000, making the total premiums paid on the policies \$735,046.

Prior to the deaths of the insureds, the policyholders had the right to assign the policy; to use it as collateral for a loan; to borrow against it; and to surrender it. The policies reserved the company's right to reject the policyholder's request to assign it or use it as collateral for a loan. The policies' terms also significantly restricted the amount of cash that the policyholder could extract from the policies by surrender or policy loan.

C: Investment of Policy Assets

The policies stated that no one but the investment manager may direct investments and deny the policyholder any "right to require Lighthouse to acquire a particular investment" for a separate account. The policyholder was allowed to transmit "general investment objectives and guidelines" and to offer specific investment recommendations to the investment manager. In 2006 and 2007, Butterfield Private Bank and Experta Trust Co. served as the investment managers ("Investment Manager") of the separate account. Lighthouse was required to perform "know-your-client" due diligence, to avoid violating certain laws and to ensure that the investments met the diversification requirements of section 817(h). No records existed showing Lighthouse or the Investment Manager performed independent research or meaningful due diligence with respect to any of Mr. Webber's investment directives.

Lighthouse established several companies to hold the investments in the separate accounts, including Boiler Riffle Investments, Ltd. (“Boiler Riffle”), a Bahamian company. These investment funds were owned by Lighthouse but not available to the general public or to any other Lighthouse policyholder.

Mr. Webber’s attorney explained to Mr. Webber that it was important for tax reasons that Mr. Webber not appear to exercise any control over the investments by Lighthouse, and he instructed Mr. Webber not to communicate directly with Lighthouse or the Investment Manager. Instead, Mr. Webber communicated with Lighthouse or the Investment Manager through his attorney or his accountant. There were more than 70,000 emails documenting this communication.

During the years at issue, most of Mr. Webber’s investment objectives for the policies were effectuated through a special-purpose entity (SPE). Mr. Webber offered, via his attorney or accountant, “recommendations” about assets in which the SPE should invest. According to the facts presented in the case, every investment the SPE made was an investment that Mr. Webber had recommended and virtually every security the SPE held was issued by a company in which Mr. Webber had a personal financial interest.

Mr. Webber’s attorney was aware of the Investor Control Doctrine, but concluded that it would not apply because Mr. Webber would not be in “constructive receipt” of the assets held in the separate accounts.

D: The IRS Challenge

The IRS examined Mr. Webber’s 2006 and 2007 federal income tax returns. The IRS requested to interview Mr. Webber’s accountant and issued a summons, but Mr. Webber’s attorneys moved to quash the summons. The IRS eventually interviewed the accountant and concluded that the Lighthouse structure was a “sham”; that the SPE was a Controlled Foreign Corporation (CFC) whose income was taxable to Mr. Webber under section 951 through the Bahamian trust; and that Mr. Webber was subject to tax on the income that the SPE derived from the investments it held for the policies’ separate accounts, because Mr. Webber was deemed to own the assets in the separate accounts under the Investor Control Doctrine. The IRS issued Mr. Webber a notice of deficiency, and he sought review in the Tax Court.

TAX COURT’S OPINION

The Tax Court, in a lengthy and detailed opinion, agreed with the IRS that the arrangement among Mr. Webber, the Bahamian trust, Lighthouse and the Investment Manager violated the Investor Control Doctrine. In so doing, the Court considered a number of challenges from Mr. Webber, each of which may factor into subsequent application of, and challenges to, the Investor Control Doctrine.

Mr. Webber communicated with Lighthouse or the Investment Manager through his attorney or his accountant. There were more than 70,000 emails documenting this communication.

A: Burden of Proof

When contesting the determinations set forth in a notice of deficiency, a taxpayer bears the initial burden of proof. If the taxpayer produces “credible evidence with respect to any factual issue,” the burden of proof will shift to the Commissioner if certain conditions are met. According to *Higbee v. Commissioner*, “credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted.” The Court stated that the taxpayer must have “cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews” to qualify for a shift in the burden of proof.

The Tax Court held the burden of proof remained on Mr. Webber because he failed to “cooperate with reasonable requests by the Secretary for witnesses, * * *, meetings, and interviews.”²⁵ The court found Mr. Webber did not introduce “credible evidence” on the central factual issues in this case because he did not fully cooperate with the IRS’ discovery requests by rejecting the request to interview his accountant. The IRS had to issue the summons, and Mr. Webber’s attorneys moved to quash it. Thus, the Court held that Mr. Webber failed to cooperate with reasonable requests by the Secretary and burden of proof remained on Mr. Webber.

While this may appear to be a mere procedural matter in this case, it does present an interesting question. As a result of this ruling, Mr. Webber is put in the position of having to prove a negative—that he exerted no control over the investments made to support the life insurance policies. The Court goes to great lengths in this case to provide evidence of the control that Mr. Webber did, in fact, exert over the Investment Manager and other parties to the transaction. It is interesting to ask, however, whether the IRS would have had an easy time proving the existence of investor control if the burden had been with the IRS.

In this case, the Tax Court believed the facts demonstrated fairly conclusively that Mr. Webber was calling the shots when it came to the investments supporting the variable policies. We are left



to wonder how the Court might have ruled in a less clear-cut case. What if there is less overwhelming evidence? What if the Investment Manager did exercise some independence? If the taxpayer has the burden of proof, it may still be challenging to demonstrate the negative—that no investor control exists. But if the burden is on the government instead—because the taxpayer was cooperative and succeeded in shifting the burden to the government—what facts are required to demonstrate that the policyholder was exerting control? Are a few emails enough? In this case, this procedural matter may not have altered the outcome, but who bears the burden of proof in a future case may be a much more important matter and could affect the outcome of the case.

B: The Investor Control Doctrine

Having determined that Mr. Webber bore the burden of proof in this case, the Court then turned its attention to the core issue—whether, under application of the Investor Control Doctrine, Mr. Webber, and not Lighthouse, would be treated as the owner of the assets supporting the life insurance policies for federal income tax purposes. The Court looked to the history of the doctrine and laid out those facts that, in the Court’s view, demonstrated the presence of investor control. According to the Court, the power to direct what specific investments will be held in the separate account would be the core “incidents of ownership” in determining the true owner of the assets in those accounts for federal tax purposes. For policyholders not to be treated as owners, control over individual investment decisions

must not be in the hands of the policyholders. Other factors of “incidents of ownership” include the powers to vote securities in the separate account; to exercise other rights or options relative to the investments; to extract money from the account; and to derive “effective benefit” from the underlying assets.

Mr. Webber challenged the Court’s deference to the published guidance of the IRS and Treasury Department, in particular Rev. Rul. 2003-91. While it is not customary for a court to defer to a revenue ruling, the Tax Court held that deference in this case was appropriate because the investor control rulings reflected a consistent and well-grounded process of development of the doctrine over more than 40 years and was based in judicial precedent.²⁷ In rejecting Mr. Webber’s challenge, the Court relied on *Skidmore v. Swift & Co.*,²⁸ which found that deference was appropriate when the length of time an agency held specific views suggested that the position had been given careful consideration. The Court also relied on *Christoffersen v. United States*²⁹ to justify its deference to *Skidmore*. In *Christoffersen*, the taxpayers purchased a variable annuity supported by a separate account from a life insurance company. The Court of Appeals for the Eighth Circuit held that, although the taxpayers had surrendered a few ownership rights, the taxpayers were still the beneficial owners of the investment funds. From the Court’s view, the payment of annuity premiums, management fees and the limitation of withdrawals to cash, rather than shares, did not reflect a lack of ownership or control. The Court made clear that *Inv. Annuity, Inc. v. Blumenthal*,³⁰ which held Revenue Ruling 77-85 invalid, could not apply here, because it was reversed due to the District Court’s lack of jurisdiction.

Again, a different ruling on a procedural matter, in this case deference to IRS published guidance, might have produced a different outcome. To be sure, the Court goes to great lengths to lay out all the evidence that Mr. Webber was controlling the investment decisions affecting the policies. Furthermore, even without deferring to Rev. Rul. 2003-91, the Court could have constructed similar reasoning from judicial precedent; the Court’s job was made easier by the IRS and Treasury’s continued application and development of the Investor Control Doctrine. If the IRS had issued Rev. Rul. 77-85 and never revisited the Investor Control Doctrine, the outcome might have been different. But the Investor Control Doctrine was not a dusty relic of a 40-year-old revenue ruling; the IRS had continued to apply the doctrine, courts had considered its application, and even Mr. Webber and his legal team thought the doctrine viable enough that they determined that communication directly between Mr. Webber and the Investment Manager would violate the doctrine.

C: Ownership of the Separate Account Assets

The Court agreed with the IRS that Mr. Webber, under the Investor Control Doctrine, should be treated as the owner of the

investments in the separate accounts for federal income tax purposes. In reaching this conclusion, the Court considered whether he retained significant incidents of ownership and the actual level of control over investment that Mr. Webber exercised. The Court held Mr. Webber enjoyed significant incidents of ownership and all dividends, interest, capital gains, and other income received by the separate accounts during tax years were includible in his gross income under section 61.

Mr. Webber had the power to direct investments for the separate accounts by instructing the Investment Manager to buy, sell and exchange securities and other assets in which Mr. Webber wished to invest. All the facts presented in the opinion demonstrated that the Investment Manager merely followed Mr. Webber's recommendations. Virtually every security Boiler Riffle's separate account held (apart from certain brokerage funds) was issued by a startup company in which Mr. Webber had a personal financial interest. Mr. Webber recommended every investment the Investment Manager made. According to the Court, Mr. Webber produced no evidence establishing that either Lighthouse or the investment manager engaged in independent research or meaningful due diligence. Mr. Webber often negotiated a deal directly with a third party, and then recommended the Investment Manager implement the deal. In sum, Mr. Webber actively managed the assets in the separate accounts by directing the Investment Manager to buy, sell and exchange securities and other property as he wished.

Mr. Webber also had the power to vote shares and exercise other options by dictating what actions the Investment Manager would take with respect to its ongoing investments. The Court found that he repeatedly directed what actions the separate account should take in its capacity as a shareholder of the startup companies in which he was interested.

In addition, Mr. Webber had numerous ways to extract cash from the separate accounts. The terms of each policy permitted the policyholder to assign it; to use it as collateral for a loan; to borrow against it; and to surrender it. Mr. Webber contended that this case should be distinguished from *Christoffersen*, since there was a restriction on the amount he could extract. The Court held the restriction was trivial, however, and found Mr. Webber could, and did, extract cash from the separate accounts by various ways—for example, by selling assets to the separate accounts. According to the Court, he could extract cash at will.

Mr. Webber also had the power to derive other benefits. He used the separate accounts to finance investments that may have been a source of personal pleasure. He regularly used the separate accounts synergistically to bolster his other positions, by using the accounts as a source of investment funds.

Mr. Webber's Counterclaims

Mr. Webber contended that he should not be taxed on the income realized by the separate account during 2006–2007 because he was not in “constructive receipt” of this income. According to Mr. Webber, he faced a substantial limitation or restriction on access to the income because he could enjoy actual receipt of that income only by surrendering the policies for their cash surrender value. The Court found, however, that the constructive receipt doctrine could not apply in this case, because that doctrine addressed a different problem from the Investor Control Doctrine. Also, if Mr. Webber were treated as the real owner, he would be treated as having actually received what the separate accounts actually received, so “constructive receipt” was not necessary. Stated another way, application of the Investor Control Doctrine trumps, or reverses, the constructive receipt analysis.

Mr. Webber also argued that the Investor Control Doctrine should not apply to life insurance contracts, because revenue rulings regarding this doctrine addressed variable annuity contracts. Although Rev. Ruls. 2003-91 and 2003-92 applied the doctrine to segregated asset accounts supporting variable life insurance contracts, Mr. Webber contended those rulings were not thoroughly considered as to the application of investor control to life insurance. The Court disagreed. The Court held that the statutory language in section 817(d)(2) fully supported the IRS' position that variable life insurance and variable annuities should be treated similarly.

Mr. Webber also contended the Investor Control Doctrine should not apply in this case because the risk was shifted by purchasing the insurance products from Lighthouse. In his view, the doctrine should apply only when the policyholder occupied essentially the same position that he would have occupied if he had purchased the assets in the separate account directly. The Court concluded that the existence of insurance risk alone did not make Lighthouse the owner of the assets. Moreover, Lighthouse was reinsured by Hannover Re and the remaining risk was actually quite small. The Court also emphasized that, when the existing mortality risk was fully compensated by mortality risk charges paid by the policyholder, the insurer's obligation to pay a minimum death benefit does not determine who owns the separate account assets.

Mr. Webber argued that the Investor Control Doctrine could not apply to an insurance policy that satisfies the statutory definition under section 7702. The Court again rejected this contention, as the fact the policies constitute “life insurance contracts” under section 7702(a) did not determine the owner of the separate account assets for tax purposes. Alternatively, Mr. Webber argued

that, if the Investor Control Doctrine applied to treat him as the owner of the separate account assets, the tax results should be dictated by section 7702(g), which defined the “income of the contract” as “the increase in the net surrender value,” plus “the cost of life insurance protection provided,” minus “the premiums paid.” The Court disagreed with this counterargument, as section 7702(g) only applied when the life insurance contract failed to meet the requirements under section 7702(a).

Finally, Mr. Webber contended section 817(h) would supersede the Investor Control Doctrine. The Court again disagreed. The Court pointed out that Congress expressed no intention to displace the Investor Control Doctrine. In section 817(h), Congress directed the Commissioner to promulgate standards for determining when investments in a segregated account, though actually selected by an insurance company, are made at the direction of the investor. According to the Court, it would be contrary to congressional intent if section 817(h) disabled the Investor Control Doctrine. The Court made clear that the enactment of section 817(h) did not displace the investor doctrine principles.

D: Accuracy-Related Penalty

Interestingly, after a lengthy opinion demonstrating all the different ways that Mr. Webber, with the aid of his attorney and accountant, exercised control over the assets supporting his variable life insurance policies, the Court declined to uphold the accuracy-related penalty the IRS imposed on Mr. Webber. Section 6662 imposes a 20 percent accuracy-related penalty upon the portion of any underpayment of tax that is attributable (among other things) to a substantial understatement of income tax. For the section 6662 penalty, the Commissioner bears the burden of production. If the Commissioner satisfies this burden, the taxpayer then bears the ultimate burden of production. If it is shown that the taxpayer acted in good faith, the penalty will not be imposed. A taxpayer can demonstrate reasonable cause and good faith by showing reliance on professional tax advice.

In this case, the Court held that Mr. Webber’s reliance on his attorney’s advice was reasonable, so he was not liable for the accuracy-related penalty. According to the court, the attorney was a competent tax adviser. He reviewed several opinion letters concerning the Investor Control Doctrine, which concluded that the Lighthouse policies would comply with U.S. tax laws and avoid application of the doctrine. By informing Mr. Webber that he concurred in these opinions, the attorney provided professional tax service to Mr. Webber and Mr. Webber relied on this advice in good faith. In addition, the fact that Mr. Webber did not attempt to hide his estate plan from the IRS also supported his testimony that he believed the strategy would successfully withstand the IRS scrutiny.

DISCUSSION

The Tax Court’s analysis in *Webber* is detailed and thorough, and few could argue that it reaches the wrong conclusion. Practitioners, including Mr. Webber’s attorney, have continued to consider the Investor Control Doctrine a viable and important consideration when establishing and maintaining variable life insurance or annuity arrangements, especially in the private placement market. Adding the reasoning of *Webber* to the IRS guidance, especially the most recent statement in Rev. Ruls. 2003-91 and 2003-92, offers taxpayers some valuable guidance of what to do, and perhaps more importantly, what not to do.

Significant questions remain, however, and if *Webber* provides any lasting assistance to taxpayers considering purchasing a variable product, it is that it strongly reinforces the intensely factual nature of the investor control analysis. The timing of the *Webber* decision is important because private placement life insurance and annuity contracts are increasingly being purchased by high net worth individuals and arrangements are being used in a number of tax-planning arrangements. Similarly, private equity and other alternative investment firms are establishing insurance-dedicated funds that mirror publicly available investments they manage—commonly referred to as clone funds. Anyone contemplating entering into such an arrangement should carefully consider the Investor Control Doctrine and its application to the particular arrangement under consideration.

The Investor Control Doctrine applies at the time an arrangement is established as well as throughout the life span of the arrangement. There is no such thing as a “foot fault” or a correction option as there is in the diversification rules of section 817(h). Once a transaction fails investor control, it is essentially “game over.” But given the factual nature of the analysis, there is little certainty for taxpayers, except that transactions fitting within the IRS guidance are probably sound and transactions resembling *Webber* are probably in trouble.

There are some clues to the facts that tend to demonstrate investor control and facts that tend to demonstrate a lack of control. For example, the relationships of the various parties to the transaction are important. If the policyholder is in a position to exert control over the insurance company, the investment adviser or any other party to the transaction in such a way that a party is likely to act at the policyholder’s behest and not independently, there may be an investor control problem.

As the IRS guidance points out, communications between the policyholder and any of the parties involved in making investment decisions should be viewed carefully for influence or control. But left unaddressed is what type of communication, if any, is not a problem. What about sharing the name of the investment manager, past performance of a fund, and information on significant holdings of a fund? Does this rise to the level of

establishing the type of pre-arranged plan to invest in specific investments that Rev. Rul. 2003-91 was concerned with? How general must the description of the investment strategy of a fund or investment option be to satisfy investor control? What about proprietary investment formulas?

The relationship between the purchaser of a policy and the insurance company or investment manager must also be monitored. It is increasingly common that investment managers establish an insurance-dedicated fund that is a clone of a popular investment vehicle. The IRS has indicated that clone funds are sufficiently different from the publicly available fund, because of different cash flows and the need to comply with the diversification requirements, that these funds will not generally be viewed as publicly available.³¹ But how should we view a transaction in which an existing customer of the fund manager decides to switch part of the investment from the public option to the insurance-dedicated fund through the purchase of a variable contract? Is it possible to construct sufficient communication walls between the client's general investments and the activities of the insurance-dedicated fund to avoid the appearance of investor control? Does the size of the organization matter? Can a household name investment management company succeed in creating the appropriate safeguards where boutique firms cannot?

Clearly, *Webber* is not the last word in the Investor Control Doctrine. It provides additional guideposts for taxpayers. In many ways, it, along with Rev. Rul. 2003-91, helps focus the discussion and analysis on the facts that are likely to be most heavily weighed; e.g., the relationships between the parties and the communications between them. At the end of the day, however, taxpayers entering into variable contract private placement arrangements and organizations looking to establish insurance-dedicated funds could need more guidance from the IRS to be certain that their transaction will survive an investor control challenge. Until then, we are left with the tax version of Justice Stewart's famous standard—we know it when we see it. ■

Note: The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.

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END NOTES

- ¹ With apologies to Justice Stewart—See *Jacobellis v Ohio*, 378 U.S. 184, 197 (1964).
- ² The authors wish to thank Na Kim and Kristin Norberg for their assistance.
- ³ Unless otherwise noted, all references to the Code or to “sections” are to the Internal Revenue Code of 1986, as amended.
- ⁴ 144 T.C. No. 17 (June 30, 2015).
- ⁵ 2003-2 C.B. 347.
- ⁶ 309 U.S. 331 (1940).
- ⁷ *Clifford*, 309 U.S. at 335.
- ⁸ *Id.* at 336.
- ⁹ 1977-1 C.B. 12.
- ¹⁰ See Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12.
- ¹¹ 1981-2 C.B. 13.
- ¹² 1982-1 C.B. 11.
- ¹³ The IRS, relying on the published guidance as well as the holdings of *Christoffersen and Blumenthal*, issued a number of private letter rulings over the decades between issuance of Rev. Rul. 77-85 and the Tax Court's decision in *Webber*, further reinforcing the government's belief in the continued viability of the Investor Control Doctrine.
- ¹⁴ 749 F.2d 513 (8th Cir. 1985), rev'g 578 F. Supp. 398 (N.D. Iowa 1984).
- ¹⁵ *Id.* at 515.
- ¹⁶ *Id.*
- ¹⁷ 442 F. Supp. 681 (D.D.C. 1977), rev'd, 609 F.2d 1, 197 (D.C. Cir. 1979).
- ¹⁸ See, for example, LTR 201515001 (Oct. 10, 2014); LTR 200105012 (June 22, 2012); ILM 200840043 (June 10, 2008); LTR 200601007 (Sept. 30, 2005); LTR 200010020 (Dec. 6, 1999); LTR 9748035 (Nov. 28, 1997); LTR 9433030 (Aug. 22, 1994). It is worth noting that many believe that LTR 9433030 provided much of the reasoning employed by the IRS and Treasury in the guidance that was at issue in the *Webber* case.
- ¹⁹ 1999-2 C.B. 598.
- ²⁰ 2003-2 C.B. 347 and 350.
- ²¹ 2008-2 C.B. 1001.
- ²² Rev. Rul. 2003-91, *supra* note 20.
- ²³ In this case, the parties expressly agreed that the contracts met the statutory definitions. Whether this was actually the case or a litigation strategy, it is unlikely that other situations will be as clear-cut. In many private placement transactions, investor control questions often lead to other questions, most notably satisfaction of the section 817(h) diversification requirements. Failure to meet those requirements could have broader implications for the parties to the transaction than failure to satisfy investor control alone presents. If a contract fails to meet the investor control requirements, the income is taxed currently to the contract holder. If other rules, like those under sections 817(h), 7702, 7702A or even 72(s) and 72(u), are not met, the contract may not qualify as a life insurance or annuity contract for federal income tax purposes, creating possible reserving or life company qualification questions for the issuing insurance company.
- ²⁴ 116 T.C. 438, 442 (2001).
- ²⁵ *Webber*, *supra* note 4, at 45.
- ²⁶ *Id.*, at 60–61.
- ²⁷ *Id.*, at 65.
- ²⁸ 323 U.S. 134, 140, 65 S. Ct. 161, 89 L. Ed. 124 (1944).
- ²⁹ 749 F.2d 513 (8th Cir. 1985), rev'g 578 F. Supp. 398 (N.D. Iowa 1984).
- ³⁰ 442 F. Supp. 681 (D.D.C. 1977), rev'd, 609 F.2d 1 (D.C. Cir. 1979).
- ³¹ LTR 201417007 (April 25, 2014).

IRS Applies Strict Reading of Section 72(s)

By Mark E. Griffin and Alison R. Peak

In August 2015, the Internal Revenue Service (IRS) released PLR 201532026 (April 23, 2015) (or the “Ruling”) applying the after-death distribution rules for nonqualified annuity contracts under section 72(s)¹ to a non-spouse beneficiary (“Taxpayer”) under two nonqualified deferred annuity contracts.² Even though Taxpayer requested to receive her interest in the contracts over her life expectancy, the requested distributions did not actually begin within one year after the holder’s death as required by the “life expectancy rule” under section 72(s)(2) (described below) because of delays related to another individual’s competing claim to the proceeds of the contracts. Accordingly, the IRS concluded that Taxpayer’s interests in the contracts must be distributed within five years of the contract holder’s death under section 72(s)(1)(B) (the “five-year rule”). This Ruling appears to be the first private letter ruling addressing the consequences of failing to begin distributions from a nonqualified annuity contract under the life expectancy rule within one year after the holder’s death.

Set forth below is a discussion of the rules and background of section 72(s), followed by a discussion of the Ruling. In addition, this article considers whether the IRS might have reached a different conclusion in the Ruling if (1) the requested distributions actually commenced within one year of the contract holder’s death, *e.g.*, the distributions were paid into an escrow account, (2) the required minimum distribution (RMD) rules that apply to individual retirement arrangements (IRAs), section 403(b) plans, and qualified retirement plans (collectively, “qualified arrangements”) could be applied, or (3) the facts and circumstances could cause a taxpayer to be in constructive receipt of the missed payments under the life expectancy rule.

SECTION 72(S) IN GENERAL

Section 72(s) provides that, with certain exceptions, a nonqualified annuity contract will not be treated as an annuity contract for federal income tax purposes unless it provides certain distribution requirements that apply after the death of any “holder” of the contract. These requirements differ depending on whether a holder dies before the “annuity starting date”³ or dies on or after that date.

Specifically, if a holder dies on or after the annuity starting date, any remaining interest must be distributed at least as rapidly as under the method of distributions being used as of the date of his death.⁴ If a holder dies before the annuity starting date (as under the facts in the Ruling), the entire interest in the contract must be distributed within five years after the death of the holder (*i.e.*, under the five-year rule). However, section 72(s)(2) sets forth an exception (the life expectancy rule) under which any portion of the holder’s interest may be distributed over the life of the “designated beneficiary,”⁵ or over a period not extending beyond the designated beneficiary’s life expectancy, if “such distributions begin not later than 1 year after the date of the holder’s death or such later date as the Secretary may by regulations prescribe.” The regulations under section 72 do not address the after-death distribution rules in section 72(s).

Section 72(s) also includes several special rules and exceptions not relevant to the Ruling. In particular, section 72(s)(3) provides generally that if the designated beneficiary is the holder’s surviving spouse, the surviving spouse is treated as the holder of the contract, thereby allowing the surviving spouse to continue the contract as his or her own contract. This spousal continuation delays the application of the after-death distribution rules until after the death of the surviving spouse.⁶ In addition, section 72(s)(6) and (7) provide that if the contract holder is not an individual, the “primary annuitant”⁷ is treated as the holder of the contract, and the death or change of the primary annuitant is treated as the death of the holder that triggers the after-death distribution requirements. Also, section 72(s)(5) provides generally that the after-death distribution rules do not apply to an annuity contract that (1) is issued as or in connection with a qualified arrangement, which is subject to the RMD rules in section 401(a)(9), or (2) is a “qualified funding asset” under rules for structured settlements in section 130(d).

THE LEGISLATIVE HISTORY OF SECTION 72(S)

Section 72(s) was added to the Code as part of the Deficit Reduction Act of 1984 to prevent continued deferral of the “inside build-up” under annuity contracts after the death of a contract holder.⁸ Prior to enactment of section 72(s), no income was recognized to the recipient of an annuity by reason of the death of the contract owner. Rather, the income accumulated in the contract was includible in gross income only when the beneficiary chose to take distributions from the contract. Congress concluded that the continued deferral of tax on the income in an annuity contract should not be allowed when the annuity contract is passed to another generation (other than a spouse). Congress enacted section 72(s) as a means to address this post-death tax deferral.

Under the initial version of section 72(s) that was passed by the House of Representatives in 1984, the entire amount of the gain



in the contract as of the contract holder's death would have been includible in the holder's gross income, and the investment in the contract would have been increased by that amount. This approach effectively would have reversed the income in respect of a decedent rule that applied at that time (under which a taxpayer who inherited the right to income stood in the shoes of the decedent and included the amount in income when received) by shifting the tax on the income accumulated in a deferred annuity from the surviving beneficiary to the decedent contract holder.⁹

The House approach was rejected by the Senate,¹⁰ and Congress ultimately adopted the approach reflected in the current statute. It appears Congress did not want to shift the income tax burden to the estate of the deceased owner and to overturn the rules applicable at that time to beneficiaries of annuity contracts.¹¹ Congress instead modified the rules to generally conform them to those applicable to qualified arrangements.¹² In this regard, Congress had indicated that deferral of tax on the investment income of annuities is justified by the retirement savings purpose of annuities.¹³

THE FACTS OF PLR 201532026

The deceased individual in PLR 201532026 owned two non-qualified deferred annuity contracts, each issued by a different insurance company. The individual died prior to the annuity starting date for each contract. Taxpayer was named a partial, non-spouse beneficiary under each of the contracts. Taxpayer received forms from each company setting forth distribution options, and she elected a ten-year payout option of her beneficiary share of each contract. The Ruling indicates that Taxpayer provided the election forms to each company within one year of the owner's death. Hence, if the requested distributions under the ten-year payout option had timely commenced, they would have been made in accordance with the life expectancy rule.

Unfortunately for Taxpayer, Individual B asserted a competing claim to the proceeds of the contracts. Individual B's counsel wrote letters to the two companies requesting that they defer distributions pending the conclusion of the legal dispute regarding the beneficiaries. As a result of these letters, the companies froze the distributions from the contracts before any distributions were made to Taxpayer.

Individual B eventually released any claim to the proceeds of the contracts. However, this release occurred more than a year after the contract owner's death. The companies took the position that since distributions under the contracts had not begun within one year of the contract holder's death, as required under the life expectancy rule, Taxpayer's interests in the contracts could not be distributed under that rule, and thus could not be distributed as Taxpayer requested under the ten-year payout option. Rather, the companies reasoned, section 72 requires that the entire proceeds payable to Taxpayer must be distributed within five years after the owner's death.

The IRS agreed with the companies' determination that the proceeds payable to Taxpayer must be distributed under the five-year rule, notwithstanding Taxpayer's timely election to begin receiving distributions under the ten-year payout option in accordance with the life expectancy rule. The IRS noted that section 72(s)(2)(C) fixes the time by which distributions under the life expectancy rule must begin to a date that is "not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe." Based on a strict reading of this section, the IRS reasoned that since this distribution commencement date under the life expectancy rule has not been extended under regulations, and the companies did not actually begin making distributions to Taxpayer until more than a year after the contract owner's death, the entire proceeds of

the contracts had to be paid out within five years of the owner's death, i.e., under the five-year rule.

THOUGHTS AND OBSERVATIONS

Query whether there might be facts or theories not expressed in the Ruling on which the IRS could have reached a different conclusion.

Actual commencement of payments. For instance, it is possible that the IRS would have permitted distributions to be made to Taxpayer under the ten-year payout option, in accordance with the life expectancy rule, if the companies actually began making the requested distributions within one year of the contract holder's death. In light of the uncertainty about who was entitled to the proceeds of the contracts, it is understandable that the companies would not want to make any distributions to Taxpayer. This ex-

Even though Taxpayer requested to receive her interest in the contracts over her life expectancy... the IRS concluded that Taxpayer's interests in the contracts must be distributed within five years of the contract holder's death...

plains why the companies did not honor Taxpayer's election of the ten-year payout option and froze distributions from the contracts.

However, Taxpayer and Individual B could have directed the companies to pay the requested distributions into an escrow account pending the resolution of Individual B's competing claim. If so, perhaps the actual payment of such amounts from the contracts (albeit into the escrow account rather than to Taxpayer) could have been sufficient to satisfy the requirement under the life expectancy rule that distributions commence within one year of the holder's death. Even so, this approach might not have presented a clean resolution of the matter because the use of an escrow account would have raised other issues. For example, there would be questions about the proper tax treatment of the distributions transferred to the escrow account, including whether such amounts need to be tax reported in order for the distributions to satisfy the life expectancy rule and to whom they should be reported. In addition, the tax treatment of the amounts held in the escrow account pending the resolution of Individual B's competing claim would be uncertain, including how to tax report the interest that would be paid on such account.

Contrasting the RMD rules. As noted above, the Treasury Department and the IRS have not published regulations interpreting the life expectancy rule under section 72(s). This is in contrast to the after-death distribution rules applicable to qualified arrangements, where the IRS and Treasury have published extensive regulations interpreting these requirements. In this regard, the five-year rule and life expectancy rule that apply under section 72(s) have their counterparts in section 401(a)(9)(B)(ii) and (iii), respectively.

In particular, section 401(a)(9)(B)(ii) (i.e., the RMD counterpart to the five-year rule) provides that if an employee dies before the required beginning date, any remaining interest must be distributed within five years after the employee's death. Section 401(a)(9)(B)(iii) (i.e., the RMD counterpart to the life expectancy rule) provides an exception to this five-year rule for qualified arrangements under which a portion of the employee's interest may be distributed over the life of a "designated beneficiary,"¹⁴ or over a period not extending beyond the designated beneficiary's life expectancy, if "such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe." For ease of discussion, we will also refer to the RMD counterparts of these rules simply as the five-year rule and life expectancy rule.¹⁵

The RMD regulations have fairly comprehensive rules interpreting the after-death distribution requirements in section 401(a)(9), including rules relating to elections that may be made and default rules that apply in the absence of an election. For example, under Treas. Reg. section 1.401(a)(9)-3, Q&A-4, a qualified arrangement may permit the employee (or beneficiary) to elect whether the five-year rule or the life expectancy rule applies to distributions after the death of an employee who has a designated beneficiary. The regulations provide that the election must be made no later than the earlier of the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule or the end of the calendar year that contains the fifth anniversary of the date of death of the employee. As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. In addition, the plan may also specify a default method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method applies, distribution must be made in accordance with the life expectancy rule if there is a designated beneficiary and the five-year rule if there is no designated beneficiary.

The following discusses several private letter rulings in which the IRS considered whether the five-year rule or life expectan-



cy rule applies when distributions of a designated beneficiary's interest in a qualified arrangement do not actually commence within the year following the employee's death as required under the life expectancy rule for qualified arrangements. In making this determination, the IRS generally looked to see whether an election had been made or whether the terms of the qualified arrangement defaulted to the five-year rule or life expectancy rule. Where the life expectancy rule was the default distribution method, the IRS permitted distributions to be made under that rule, notwithstanding that such distributions did not actually begin within the one-year period required under that rule.

- In PLR 201417027 (Jan. 30, 2014) the IRS addressed the failure of distributions to commence within one year of an employee's death. The case involved two daughters of a deceased participant of a profit sharing plan (Plan D) where the participant died prior to the required beginning date.¹⁶ As permitted under the RMD regulations, the terms of Plan D provide that the life expectancy rule applies as the default rule if no election is made between the life expectancy rule and the five-year rule.¹⁷ Due to circumstances beyond the daughters' control, the executor of the deceased participant's estate failed to notify them that they were beneficiaries under the plan by the end of the calendar year following the year of the employee's death. Accordingly, the daughters did not timely elect a distribution method, and thus the life expectancy rule applied by default. As a result, the deceased parent's interest in Plan D will be distributed to the daughters in accordance with the life expectancy rule over the life expectancy of the older daughter.¹⁸ In addition, the IRS concluded that the daughters were liable for the 50 percent excise tax under section 4974 on the missed distributions under the life expectancy rule, subject to a possible waiver of the excise tax under section 4974(d).

- Similarly, PLR 200811028 (Dec. 21, 2007) involved an individual (Taxpayer A) who was the sole beneficiary under two IRAs held by Decedent B who died in 2002 prior to his required beginning date. Under the terms of the IRAs, the life expectancy rule was the default rule, subject to the designated beneficiary's ability to elect to receive distributions under the five-year rule. Taxpayer A made no election for the five-year rule to apply with respect to either IRA. For reasons not explained in the ruling, Taxpayer A failed to take distributions under the life expectancy rule for 2003 and 2004. The RMDs for 2003, 2004 and 2005 were taken in the aggregate in 2005. Taxpayer A later paid the 50 percent excise tax under section 4974 for failing to timely receive the RMDs determined under the life expectancy rule for 2003 and 2004. The IRS concluded that the life expectancy rule applied to distributions from both IRAs.
- In contrast, PLR 9812034 (Dec. 22, 1997) involved an IRA owner who died prior to her required beginning date. For almost four years after her death, her brother (Taxpayer A) was unaware that he was the designated beneficiary of the IRA. Taxpayer A requested relief to receive his interest in the IRA under the life expectancy rule in section 401(a)(9). The IRS reasoned that the time a non-spouse beneficiary, like Taxpayer A, must begin to receive a distribution "is expressly fixed by the terms of the IRA." Under the IRA in this case, distributions would be made under the five-year rule unless the designated beneficiary elected, by Dec. 31 of the year following the year of the owner's death, to apply the life expectancy rule. The IRS concluded that since Taxpayer A failed to timely elect the life expectancy rule, the entire remaining interest in the IRA was required to be distributed under the five-year rule.

It is interesting to note that in PLR 201417027 and PLR 9812034, discussed above, the IRS refused to extend the time by which distributions must begin under the life expectancy rule beyond the one-year period expressed in the rule. The taxpayers requested that the IRS extend this one-year period under the IRS' authority in Treas. Reg. section 301.9100-1 to grant a taxpayer a reasonable extension of the time fixed by a regulation, revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin for the making of certain elections or applications for relief. The IRS explained that although a designated beneficiary may elect to determine whether to apply the five-year rule or life expectancy rule, the date by which distributions must commence under the life expectancy rule is fixed by the Code and may not be extended by operation of Treas. Reg. section 301.9100-1. Hence, even where the IRS concluded in PLR 201417027 that the life expectancy rule applied, the distributions were required to begin within one year of the employee's death and thus the 50 percent excise tax (unless waived) applied to the missed payments.

As noted above, the after-death distribution rules set forth in section 72(s) are intended to conform to the similar after-death distribution requirements set forth in the RMD rules for qualified arrangements. However, because Treasury and IRS have not published regulations interpreting section 72(s), it is not clear whether a taxpayer could rely on the regulations under section 401(a)(9) when interpreting how section 72(s) should apply to distributions to beneficiaries from annuity contracts. In order for Taxpayer to get a different result under the Ruling, the IRS would have had to respect Taxpayer's request as a valid election notwithstanding the fact that distributions did not timely begin.

Constructive receipt. Another potential argument that could be made is that, based on the facts and circumstances, a beneficiary is in constructive receipt of the missed payments under the life expectancy rule and thus distributions could continue to be made under that rule. For example, assume the designated beneficiary elects to receive distributions under the life expectancy rule and the issuer accepts the election but inadvertently fails to commence making those distributions within one year of the contract holder's death. The issuer's acceptance of the election arguably gives rise to a right of the designated beneficiary under the terms of the contract, including the terms of the election, to receive the elected distributions in accordance with the life expectancy rule. If under the facts and circumstances the designated beneficiary is treated for federal income tax purposes as being in constructive receipt of the elected distributions, this treatment could support the view that distributions were deemed to have begun within one year of the holder's death, and thus that the life expectancy rule applies even though the distributions did not actually begin within that time.¹⁹

It appears that the IRS has applied the constructive receipt doctrine in the context of section 72(s) in another set of identical rulings, i.e., PLRs 201302015 and 201302016 (July 13, 2012).²⁰ Those rulings addressed whether an after-death distribution option (the "new distribution option") to be offered to beneficiaries under nonqualified annuity contracts with guaranteed withdrawal benefit riders will satisfy section 72(s). The new distribution option would allow a beneficiary who is not the spouse of a deceased owner of the annuity (i.e., a "non-spouse beneficiary") to continue the annuity contract and the guaranteed withdrawal benefit rider after the owner's death without any withdrawals from the contract. However, the insurance company will notify the non-spouse beneficiary who wishes to elect the option that she will be required to include in gross income the amount that would be includible in gross income if she instead chose to immediately receive the death benefit proceeds in a lump sum. In addition, the insurance company will send the non-spouse beneficiary a Form 1099-R reporting the amount she will be treated as receiving for tax purposes

and the amount that will be taxable. The rulings conclude that the option will satisfy the requirements of section 72(s) based on the premise that the purpose of section 72(s) is to prevent additional tax deferral once the owner of an annuity contract has died.

In these rulings, the IRS seems to reason that as long as the deferral ends (within the time frame required by section 72(s)), the requirements of section 72(s) are met irrespective of whether any amount is *actually* distributed from the contract. The rulings view tax deferral as ending because the death benefit will be included in the non-spouse beneficiary's income. The rulings seem to say that the reason the death benefit is includible in the non-spouse beneficiary's income is because, based on the facts and circumstances involving the election of the distribution option, the non-spouse beneficiary is in constructive receipt of the death benefit proceeds. Thus, treating the amounts as distributed and reportable on a Form 1099-R would be appropriate.

Without knowing the additional facts in the Ruling, it does not seem likely that Taxpayer would have been in constructive receipt of the payments simply by requesting the life expectancy rule because the companies did not honor the request in light of Individual B's competing claim. In this regard, a mere election to include an amount in income would not be consistent with the constructive receipt requirements in section 451(a) and the regulations thereunder.²¹ However, if other facts and circumstances are present that would cause a taxpayer to be viewed in constructive receipt of the missed distribution payments, arguably the life expectancy rule could still apply. In this regard, constructive receipt would require the taxpayer to include the missed distribution amounts in income and, thus, would end the tax deferral associated with those payments.

CONCLUSION

The IRS strictly applied the requirement in section 72(s) that distributions must begin within one year of the holder's death for the life expectancy rule to apply. Based on the limited facts described in the Ruling, it is hard to disagree with that result. However, there could be additional facts or theories that could be considered, which might produce a different result. It is unclear whether the IRS would be receptive to these theories because no regulations or other published guidance exists interpreting these issues under section 72(s). In fact, as noted above, the Ruling appears to be the first pronouncement of any kind from the IRS addressing the consequences of failing to begin distributions from a nonqualified deferred annuity contract under the life expectancy rule within one year after the holder's death. ■

The views expressed herein are those of the authors and do not necessarily reflect the view of Davis & Harman LLP.

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END NOTES

- ¹ Unless otherwise indicated, the term “section” refers to a section of the Internal Revenue Code of 1986, as amended (“Code”).
- ² While private letter rulings neither constitute precedent, see section 6110(k)(3), nor may be relied upon by taxpayers other than the taxpayer receiving the ruling, they are widely accepted as indicating the views of the IRS National Office at the time of issuance.
- ³ The “annuity starting date” is defined generally as the later of (1) the date the annuity obligations under the contract become fixed, and (2) the first day of the first annuity payment interval which ends on the date of the first annuity payment. Section 72(c)(4); Treas. Reg. section 1.72-4(b)(1).
- ⁴ Section 72(s)(1)(A).
- ⁵ For purposes of section 72(s), the term “designated beneficiary” is defined to mean “any individual designated a beneficiary by the holder of the contract.” Section 72(s)(4).
- ⁶ Section 72(s)(3). A similar spousal continuation rule applies to IRAs (see section 408(d)(3) and Treas. Reg. section 1.408-8, Q&A-5) but not to other types of qualified arrangements.
- ⁷ The term “primary annuitant” is defined in section 72(s)(6)(B) to mean “the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the payout under the contract.”
- ⁸ Pub. L. No. 98-369 § 222(b) (1984) (“DEFRA”). A discussion regarding the “inside buildup” of nonqualified annuity contracts appears in this issue of *TAXING TIMES*. See John T. Adney, “In the Beginning... How Are Nonqualified Annuities Taxed?” page 8.

⁹ STAFF OF THE J. COMM. ON TAX’N, DESCRIPTION OF PROVISIONS OF S. 1992 RELATING TO LIFE INSURANCE PRODUCTS AND POLICYHOLDERS, at 19 (Comm. Print 1984).

¹⁰ See H.R. 4170, 98th Cong. § 222 (as passed by Senate, May 17, 1984); S. COMM. ON FINANCE, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 580-81 (Comm. Print 1984).

¹¹ Testimony at the Senate hearings held on the version of section 72(s) included in the House bill indicate that the life insurance industry urged the Senate to reject the House approach because of objections to shifting the tax on the deferred gain in the decedent’s annuity from the beneficiary to the decedent. See, e.g., *Tax Treatment of Life Insurance Products and Policyholders: Hearing Before S. Comm. on Fin. on S. 1992*, 98th Cong. 162.

¹² H.R. REP. NO. 98-861, at 1077 (1984) (Conf. Rep.).

¹³ STAFF OF THE J. COMM. ON TAX’N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 659 (Comm. Print 1984).

¹⁴ The term “designated beneficiary” is defined for purposes of section 401(a)(9) in the same manner as that term is defined for purposes of section 72(s), i.e., to mean “any individual designated a beneficiary by the holder of the contract.” Section 401(a)(9)(E). The regulations under section 401(a)(9) expand on who is considered a designated beneficiary for purposes of that section. See Treas. Reg. section 1.401(a)(9)-4.

¹⁵ Treas. Reg. section 1.401(a)(9)-3, Q&A-3. It should be noted that unlike distributions under the life expectancy rule in section 72(s)(2), distributions under the RMD counterpart of the life expectancy rule are permitted under the section 401(a)(9) regulations to commence by the end of the calendar year following the calendar year in which the employee died.

¹⁶ PLR 201417027 also involved the deceased parent’s interest in a money purchase pension plan (Plan E). Because the document provided with respect to this plan would require a factual determination concerning plan qualification matters under section 401, the IRS declined to rule with respect to the daughters’ interest in Plan E.

¹⁷ See Treas. Reg. section 1.401(a)(9)-3, Q&A-4.

¹⁸ See Treas. Reg. section 1.401(a)(9)-5, Q&A-7(a).

¹⁹ See Treas. Reg. section 1.451-2(a) (income not actually received generally is constructively received by a taxpayer if it’s credited to his account, set apart for him, or otherwise made available and the taxpayer’s control of its receipt is not subject to substantial limitations or restrictions).

²⁰ These rulings were discussed in more detail in a prior *TAXING TIMES* article. See Alison R. Peak, Bryan W. Keene, and Joseph F. McKeever, “Applying Section 72(s) to Joint-Life GLWBs Covering Non-Spouses,” *TAXING TIMES*, May 2013, Vol. 9, No. 2.

²¹ See Treas. Reg. section 1.451-1(a).

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ACLI Update

By Pete Bautz, Mandana Parsazad and Regina Rose

BLANKS

In July, ACLI submitted comments to the National Association of Insurance Commissioners (NAIC) PBR Review Working Group (“Working Group”) on the exposed changes to the Annual Statement Blanks to accommodate principle-based reserves. The comments were focused on Exhibit 5, the Aggregate Reserve for Life Contracts. ACLI requested the entire VM-20 reserve be reported in the Life Insurance section rather than have the Excess of the VM-20 Deterministic/Stochastic Reserve over the Net Premium Reserve be reported in the Miscellaneous Reserves section. ACLI agreed that reporting of the Net Premium Reserve portion should continue as a separate line in order to allow for a clear connection between that reserve as reported in the Life Insurance section and the “Analysis of Increase in Reserves During the Year.”

At its November meeting, the Working Group made the changes to Exhibit 5 we requested and exposed until Dec. 18 the revised recommended changes. It is anticipated that if there are no substantive changes to the exposure, the Working Group will adopt the draft and send it to the Blanks Working Group for implementation. This change does not need to be formally adopted by the NAIC for annual statement purposes until 2017 blanks are finalized.

PBR GUIDANCE

On July 31, the 2015–2016 Internal Revenue Service (IRS) Priority Guidance Plan was updated to include life PBR. On Sept. 23, ACLI submitted a letter that thanked the IRS and Treasury for including life PBR on the Priority Guidance Plan, welcomed the inclusion of the treatment of stochastic reserves under section 807 of the Internal Revenue Code, and noted it was essential that the government take a fresh look at the interim guidance on Actuarial Guideline (AG) 43 in Notice 2010-29.

The letter identified three categories of issues for guidance: (1) substantive reserve guidance, (2) product qualification guidance, and (3) reserve transition guidance. These categories were described briefly, and the industry requested detailed discussion with the IRS on all guidance issues. Product qualification guidance was singled out as the most time-sensitive set of issues due



to the lead time needed to design products, secure state approvals and design systems.

UPDATE ON TAX REFORM

ACLI staff and member company representatives met on June 5 with Ways & Means (W&M) and Joint Tax Committee (JCT) staffs, and on July 24 with Senate Finance Committee (SFC) and JCT staffs regarding life insurance company taxation and tax reform. ACLI has been pursuing ongoing dialogue with W&M, SFC and JCT staffs on areas of interest that were identified in the June 5 and July 24 briefings, including reserves vs. capital, tax reserve discount rates, and a Milliman report on the tax capitalization of commissions.

While it remains unlikely that broad-based reform will be enacted before 2017, Speaker Paul Ryan and the incoming W&M chair may pursue business and/or international tax reform before that time, perhaps to address the growing problem of corporate inversions. ACLI will continue to closely monitor any congressional activity to best address member company interests.

VARIABLE ANNUITIES FRAMEWORK FOR CHANGE

At the 2015 NAIC Spring National Meeting, the Variable Annuities Issues (E) Working Group (VAIWG) was formed and given the charge to “oversee the NAIC’s efforts to study and address, as appropriate, regulatory issues resulting in variable annuity captive reinsurance transactions.”

Oliver Wyman was engaged by the NAIC to serve as a consultant to assist the VAIWG in meeting their charge and, in September,

delivered a report of observations and recommendations. The Oliver Wyman report made five sets of recommendations for improvement, which include: 1) Align economically focused hedge assets with liability valuations;

- 2) Reform Standard Scenarios (AG43 and C3P2);
- 3) Align Total Asset Requirement (TAR) and reserves;
- 4) Revise asset admissibility for derivatives and deferred tax assets (DTAs); and
- 5) Standardize capital markets assumptions.

VAIWG adopted, by exposing a variable annuity framework, the numerous changes proposed by Oliver Wyman in order to encourage strong risk management within the insurance companies and to remove the need to reinsure variable annuity business to captive reinsurers. The ACLI submitted a comment letter to VAIWG in response to the exposed framework making recommendations for improvement.

The determination of the exact changes to the statutory accounting requirements for variable annuities will be based in large part upon a quantitative impact study (QIS) performed by Oliver Wyman in cooperation with the companies who write variable annuity business. The QIS will be conducted from February through July 2016. The initial recommendations made by Oliver Wyman are intended to be used as a guide in the likely direction of the changes to the statutory requirements and in the design of the changes that will be tested in the QIS. It is possible that other solutions may be identified during and after the QIS that could ultimately be incorporated into the final changes to statutory requirements.

Tax implications will likely result from any changes to the standard scenario, hedge accounting treatment in the reserves, or admissibility of DTAs that may emerge from the QIS and ultimately be incorporated into statutory accounting requirements by the NAIC.

PENSION DE-RISKING—ERISA ADVISORY COUNCIL

One of the ERISA Advisory Council's (EAC) 2015 study topics was Model Notices and Disclosures for Pension Risk Transfers. In 2013, the EAC conducted a comprehensive study of the risk

transfer process, and its report included recommendations regarding the information needed by participants involved in risk transfers. The 2015 EAC focused specifically on the information that participants need to make informed decisions when faced with lump sum risk transfers and annuity risk transfers, and best practices for plan sponsors in communicating that information. In August 2015, the EAC made available two "draft" model notices, one for lump sum payments and one for annuity transfers. ACLI provided comments on the annuity transfer notice, which is intended to be provided to plan participants and beneficiaries prior to the transfer of pension plan payment liabilities to an insurance company. The comment letter expressed concern that the notice will both confuse participants and cause unnecessary anxiety about whether plan benefit payments will continue from the insurance company selected by the employer sponsoring the plan. Additionally, the letter questions the utility of such a notice—either where there is no action that may be taken by the participant subsequent to the transfer, or where the participant is offered a lump sum option.

In November 2015, the EAC concluded its work and presented the Department of Labor (DOL) with its recommendations and proposed notices ("Lump Sum," "Risk Transfer"). ACLI plans to engage the DOL on our concerns with the de-risking notice when the EAC's report is officially submitted to the DOL. ■

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TAXING TIMES

TIDBITS

SUBCHAPTER L: CAN YOU BELIEVE IT? CHANGE IN TAX STATUS OF AN INSURANCE COMPANY—IRS ELIMINATES CATCH-22 SITUATION

By Peter H. Winslow

An insurance company is taxed as a life insurance company under Part I of Subchapter L of the Internal Revenue Code (the “Code”) only if it satisfies a reserve ratio test found in I.R.C. § 816(a). Under this test, an insurance company is taxed as a life insurance company for its entire taxable year if the company’s life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident or health policies exceed 50 percent of its total insurance reserves. This test is performed on the basis of the mean of the opening and closing reserves for the taxable year. Because of this bright-line 50 percent reserve ratio test, insurance companies may sometimes shift tax status from nonlife to life company status and vice versa. This most frequently occurs for companies that issue a significant amount of both group cancellable and individual noncancellable accident and health insurance policies.

There can be material differences in the tax treatment of several items depending on whether the company is taxed as a nonlife company under Part II of Subchapter L or as a life company under Part I. To the extent the varying tax treatments result in timing differences, it is the Internal Revenue Service’s (IRS’) position that a change in tax status will result in changes in methods of accounting for these timing differences. Why does this matter? Before a taxpayer can implement a change in method of accounting, I.R.C. § 446(e) requires the taxpayer to secure the consent of the IRS. The IRS has detailed procedures for taxpayers to follow to secure the IRS’ consent for a change in accounting, but until recently these procedures did not permit an insurance company that changed its tax status to secure the necessary IRS consent in time to file a correct tax return. This created a classic Catch-22 situation. The Code requires the taxpayer to change to different accounting methods when it changes insurance company status, yet also precludes compliance until IRS consent is granted, which under former IRS procedures could be difficult to obtain in a timely manner.

Let’s take a typical example. Suppose an insurer issues both group cancellable disability insurance and individual noncancellable disability insurance policies. For many years, the company’s group business was dominant, but the individual market gradually expanded to such an extent that it became likely, but not certain, that the 50 percent reserve ratio test for life company qualification would be satisfied for the first time. If this were to occur, the company would shift its tax status from nonlife to life company treatment for the entire taxable year, even though it could not make an accurate calculation of mean reserves until after the year of the shift.²

Among other tax consequences, this situation could result in several timing differences. The most likely would be for experience-rated refunds on the group products, loss adjustment expenses (LAEs) and guaranty fund assessments. For life companies, experience-rated refunds are treated as policyholder dividends and deductible when accrued under the general accrual provisions of I.R.C. § 811(a). I.R.C. § 808(b)(1) specifically includes experience-rated refunds as policyholder dividends which are deductible when paid or accrued during the taxable year under I.R.C. § 808(c). For nonlife companies, experience-rated refunds may be deductible before they accrue as return premiums or policyholder dividends on a reserve basis.³

LAEs are costs that are incurred in connection with the adjustment or recording of losses.⁴ These expenses include legal expenses, salaries and expenses of the claims department as well as all other claims-related expenses whether or not specifically allocable to particular claims. For a life company, it is the IRS’ position that these expenses are deductible when accrued under I.R.C. § 811(a). Thus, according to the IRS, life companies may not deduct reserves for LAEs that do not meet the “all-events” test under I.R.C. § 461.⁵ For nonlife companies, different treatment applies for LAEs. Unpaid LAEs reported on the Annual Statement are included in the calculation of a company’s undiscounted unpaid losses under I.R.C. § 846(f)(2) and, therefore, are deductible on a reserve basis as part of discounted unpaid losses. Similarly, for guaranty fund assessments, life companies generally are required to deduct these amounts on an accrual basis.⁶ However, nonlife companies are entitled to deduct the unaccrued liability for guaranty fund assessments on a reserve basis as premium-acquisition expenses.⁷

For each of these items, the shift from nonlife to life company status would have the effect of deferring the deduction from an estimated reserve basis (nonlife treatment) to an accrual basis under the tax “all-events” test (life treatment)—a change in method of accounting according to the IRS.⁸ This has significant consequences. First, under I.R.C. § 446(e), the company would need to file a Form 3115, Application for Change in Accounting Method, with the IRS to make the required accounting method change for each item. A failure to request the change and continuation of the now-erroneous reserve method of accounting

could result in an IRS audit adjustment and the imposition of an accuracy-related penalty.⁹ Second, if the changes in accounting are implemented, they would result in adverse I.R.C. § 481 adjustments¹⁰ to the extent the current and future deductions for the experience-rated refunds, LAEs and guaranty fund assessments on an accrual basis duplicate the deductions for these items claimed in prior years on a reserve basis.

The general rule for securing the IRS' consent to a change in method of accounting is that a Form 3115 must be filed with the IRS before the close of the year of the change. For taxpayers under audit by the IRS, under prior IRS procedures, a Form 3115 was required to be filed within one of two window periods—either during the first 90 days of the change year or within the 120-day period after the IRS' audit ended.¹²

Here's what the problem was. At the time the Form 3115 request for change in accounting was required to be filed, the company may not have known whether it would satisfy the 50 percent reserve ratio test. This was particularly the case for a company under audit by the IRS that had to file the Form 3115 in the first 90 days of the year. To repeat, it is a test that depends on the amount of year-end reserves that may not be determined with accuracy until after year-end. In these circumstances, the company had several options to comply with the Code.

The first option was to file a Form 3115 requesting the change within the specified window periods explaining that the request for changes in accounting would be withdrawn if it turned out the 50 percent reserve ratio test was not satisfied. The problem with this approach was that the IRS National Office would not process Form 3115 because it has a policy not to accept accounting change requirements that have contingencies or are based on hypothetical future events.

A second option was to ignore the due date of the Form 3115 and file the form after the mean reserves had been calculated after year-end. The problem with this approach was that the year of change technically was shifted to the year after the status shift, creating the need to file a tax return using the prior now-erroneous methods for the shift year.

A third possible approach was to ignore the requirement to file a Form 3115 and unilaterally implement the change in accounting methods without the IRS' consent. While the IRS on audit was unlikely to insist that the company go back to the more favorable nonlife accounting methods, the problem with this approach was that the company would not be able to obtain the advantageous four-year spread of the adverse I.R.C. § 481 adjustment permitted under prior (and current) IRS guidance.¹³

None of these options provided a good solution to the company's dilemma. Fortunately, the IRS has recently alleviated this problem. In February 2015, the IRS published comprehensive changes to the procedures for securing IRS consent for account-

ing method changes.¹⁴ In doing so, the IRS added to its list of automatic changes in accounting any changes that result from an insurance company's shift in tax status.¹⁵ Because the IRS has now designated these changes in accounting as automatic, they can be initiated by the taxpayer without the IRS' prior consent by filing the Form 3115 with the tax return for the year of change and following the procedures in Section 6.03(1) of Rev. Proc. 2015-13. Using this approach, a taxpayer can achieve the desired four-year spread of any adverse I.R.C. § 481 adjustment. In other words, the company can wait to see what the outcome of the 50 percent reserve ratio test is after year-end, file the shift-year tax return correctly, and achieve all the benefits of a taxpayer-initiated change. So, the IRS fixed this taxpayer dilemma on its own initiative—a nice surprise. ■

END NOTES

¹ Rev. Proc. 2015-14, 2015-5 I.R.B. 450, Section 25.03.

² This situation creates problems with determining the appropriate quarterly estimated tax deposits if tax differences between nonlife and life status are material.

³ See *Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58 (1971), acq. 1973-2 C.B. 1.

⁴ Statement of Statutory Accounting Principles No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses.

⁵ See H.R. Rep. No. 99-841, at II-361 (1986); (Conf. Rep.); Staff of the J. Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 614; but see Peter H. Winslow, *Loss Adjustment Expenses for Life Insurance Companies*, TAXING TIMES, Vol. 7, Issue 3, at 40 (Sept. 2011).

⁶ See I.R.C. § 811(a); *Principal Life Ins. Co. v. United States*, 97 A.F.T.R. 2d 2006-1542 (Fed. Cl. 2006).

⁷ See Rev. Proc. 2002-46, 2002-2 C.B. 105; Peter H. Winslow and Lori J. Jones, *When are Guaranty Association Assessments Deductible?* TAXING TIMES, Vol. 2, Issue 2, at 24 (Sept. 2006).

⁸ Arguably, the shift in tax status is a change resulting from a change in the underlying facts and does not result in a change in method of accounting under Treas. Reg. § 1.446-1(e)(2)(ii)(b). This is not the IRS' position.

⁹ I.R.C. § 446(f).

¹⁰ When there is a change in accounting method, post-change taxable income is computed as if the taxpayer had always been on the new method for prior years. As a result, a change in accounting that defers deductions results in a duplication of deductions to the extent the items were deducted in prior years under the old method and will be deducted again under the new method. This is fixed by a one-time adjustment required by I.R.C. § 481 to reverse the tax effects of the duplication. Although the statute provides that the entire adjustment is made in the year of the accounting change, the IRS has the discretion to permit or require a spread of the adjustment over several years as a condition to its consent to the accounting change.

¹¹ Treas. Reg. § 1.446-1(e)(3)(i).

¹² Rev. Proc. 97-27, 1997-1 C.B. 680, Section 6.

¹³ Rev. Proc. 97-27, 1997-1 C.B. 680, Section 5.02.

¹⁴ Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

¹⁵ Rev. Proc. 2015-14, 2015-5 I.R.B. 450, Section 25.03.

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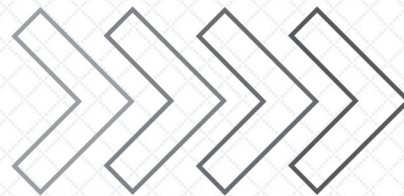
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