SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

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CONVERSATION WITH SHERYL FLUM

By the Taxation Section

Sheryl Flum, is the chief, Branch 4, IRS Office of Associate Chief Counsel (Financial Institutions and Products) at the Internal Revenue Service (IRS). *Taxing Times* sat down with Sheryl for a conversation about her role at the IRS, and to share thoughts about current tax issues facing the life insurance industry.

1. CAN YOU PROVIDE OUR READERS WITH A SUMMARY OF YOUR BACKGROUND?

Most people don't know this, but being a lawyer is my second career. I graduated from college with degrees in Finance and Accounting. I worked for a decade as an accountant, mainly in the broker/dealer area. I spent three years as an auditor with Arthur Young. My main client during that time was Morgan Stanley, and I became fascinated by the brokerage industry. For the next seven years, I worked for CS First Boston in the regulatory reporting and analysis area. My team was responsible for ensuring that the company complied with the various SEC provisions, as well as other regulatory rules issued by the Exchanges (such as the NYSE) and other regulatory agencies (like the CFTC). When I left First Boston in 1994, I was vice president of Regulatory Reporting and Analysis. I spent three blissful years in law school at the University of Miami School of Law, where I earned a full scholarship. I really enjoyed the intellectual stimulation of learning the law, and also enjoyed being in a non-work environment. When I went to law school, I intended to break away from the business world and become a public interest lawyer. But during a summer internship with a Legal Services provider, I found that the specialty wasn't right for me. Given my background, and my desire to further public good, I applied to the Department of Justice's (DOJ's) Honors Program and was offered a position with DOJ's Tax Division. I was a litigator representing the United States in tax refund cases for a little more than seven years. I joined the Office of Chief Counsel in November 2004, and became the branch chief of the Insurance Branch in March 2007.

CONTINUED ON **PAGE 5**

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To join the section, SOA members and non-members can locate a membership form on the Taxation Section Web page at *http://www.soa.org/tax*.

TO OUR READERS

A TRIBUTE TO CHRISTIAN DESROCHERS

By Brian G. King

It is with great sadness that I am writing this editorial column to the readers of *Taxing Times*. One of the great leaders in the actuarial community and current editor of *Taxing Times*, Chris DesRochers, passed away unexpectedly on Sept. 18, 2013. I thought it would be appropriate to use the editor's column for this issue to reflect on Chris' many contributions over the years to both *Taxing Times* and the Taxation Section.

Chris, along with several of his peers including Ed Robbins and Barbara Gold, had the vision over a decade ago to fill a void within the "section" structure of the Society of Actuaries to petition the Board of Governor's to create a Taxation Section. Chris was instrumental in these developmental years of our section, and his efforts were recognized through his nomination to the first Taxation Section Council in 2005. During his tenure on the council (2004-2006), he assumed leadership roles of both vice chair and chairperson. He maintained a paternalistic view of the Taxation Section after his tenure on the council, staying active as a Friend of the Council, offering his leadership and vision in making sure the Taxation Section proudly serves its members. While simply too numerous to list individually, his contributions to *Taxing Times* are impressive: 10 articles, six dialogues, four editorial columns and three chairperson columns. Rarely has an issue gone by where the name, Christian DesRochers, is not listed in the table of contents of this newsletter. He authored one article for this issue.

Writing was not his only contribution to the section. While pre-dating the Taxation Section, Chris had the idea of putting on a Product Tax Seminar in 2000 on the heels of the IRS issuing its first MEC correction program – Revenue Procedure 99-27. Given its success, the Product Tax Seminar has been a staple for the Taxation Section, running in even calendar years since 2000. While he may be remembered most as the actuarial authority of IRC Section 7702 for his outstanding work in this area, including his 1988 seminar paper published in the Transactions of the Society of Actuaries titled, *The Definition of Life Insurance Under Section 7702 of the Internal Revenue Code of Section 7702*, and his role as the lead author of the 2004 SOA textbook *Life Insurance and Modified Endowments under Internal Revenue Code Sections 7702 and 7702A*, he was equally passionate and more than competent on matters relating to the taxation of insurance companies. He was the ultimate two-way tax actuary!

Chris was always willing to volunteer his time to present at Taxation Section-sponsored events, whether it be at the Annual Meeting, Life and Annuity Symposium, webinars or other section-sponsored events. His presence will be missed greatly, but we as section members can continue to honor his vision, his passion and his desire to promote the efforts and activities of the Taxation Section by volunteering and continue what he helped start over 10 years ago. On a personnel note, I've had the privilege and honor to work beside Chris for the past 19 years, from the early days at Avon Consulting Group, through numerous company changes (Aon Consulting, Smart Business Advisory and Consulting, and LECG) to our current employment with Ernst & Young. I will forever be thankful for the opportunity he presented me when I became the first employee of Avon Consulting Group back in February of 1994. He has been a teacher, a mentor, a father figure and a friend. I will miss him dearly, as will all of the members of the Taxation Section and the Society of Actuaries.

In every editor's column, Chris would highlight an article or two and always thank the authors who provided information for publication. In his memory, I will follow suit.

This issue of *Taxing Times* features an interview with Sheryl Flum. She is chief, Branch 4, IRS Office of Associate Chief Counsel (Financial Institutions and Products) at the Internal Revenue Service. Sheryl has spoken on a number of programs for the Taxation Section, and has been a key participant in the section's Product Tax Seminar. Among the topics she addresses is the process by which guidance from the IRS on various topics is developed. *Taxing Times* also asked Sheryl about key issues in administering the current rules under Subchapter L. Not surprisingly, as has been discussed many times in *Taxing Times*, the evolution of life insurance reserves since the passage of the 1984 Act continues to present challenges in fitting principle-based reserves into the current structure of the Internal Revenue Code. On behalf of *Taxing Times*, I would like to thank Sheryl and the Internal Revenue Service for allowing us to conduct the interview.

I would like to thank everyone who contributed to the issue, as well as the editorial board members, who provide suggestions for articles as well as thoughtful comments to the authors. We invite anyone who is interested in writing articles, participating in dialogues or contributing commentary to let me know. We like to hear from our readers, and welcome any suggestions for topics.

Brian G. King, FSA, MAAA, is an executive director, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at *Brian.King3@ey.com.*

In Memory of CHARLES (BUD) FRIEDSTAT

It is also with great sadness that we report the passing of Charles (Bud) Friedstat. Bud was a charter member of the Taxation Section, serving on the first Taxation Section Council, and had been an active contributor to the section as a Friend of the Council ever since. Bud also served on the Board of Governors of both the Society of Actuaries (Society) and the Insurance Tax Conference (ITC) and is a past president of both the ITC and the Chicago Actuarial Association. Most recently, Bud was an independent consulting actuary doing primarily contract consulting work for PricewaterhouseCoopers LLP, although he had over 35 years of experience in the insurance industry working for both consulting firms and an insurance company. On behalf of the editorial staff, we would like to extend our deepest sympathy to Bud's wife Eileen and his family.

FROM THE CHAIR

MANY HANDS MAKE LIGHT WORK

By Mary Elizabeth Caramagno

As I was writing this article, we had just finalized the slate of candidates for our section council election. I had the opportunity to speak to a number of potential candidates. The one thing they all wanted to know is, "Is it a lot of work?" That's a great question, and gives me a chance to highlight one of the great assets of the Taxation Section Council: our "Friends of the Council." Besides the 12 regular council members, there are a number of other actuaries, tax attorneys and tax accountants who not only participate in our council meetings but frequently speak at face-to-face meetings and write for *Taxing Times*. Their help makes the regular council members' work much easier, and provides additional context and perspectives on tax topics.

Following the Life & Annuity Symposium in Toronto this spring, the Taxation Section sponsored a seminar titled: "Internal Revenue Code Sections 7702 and 7702A: Introduction to the Tax Rules Affecting Life Insurance Products." The seminar was a huge success and a great example of how our network of Friends benefits the section. The seminar was presented by Chris DesRochers, Brian King, John Adney and Craig Springfield, all of whom are longtime Friends of the Council (and former council members, in the case of Chris and Brian). Their seminar received outstanding feedback from participants, including high marks for overall quality and for providing leading-edge professional development. One participant remarked that it was an "excellent presentation from an expert panel that delivered just the right breadth and depth of content at a digestible pace to be very valuable and usable." Another stated: "The panel did a truly outstanding job presenting the materials. I also appreciated their willingness to answer questions on various topics. I wish our entire Operations area could have attended. I will recommend the seminar to others in our organization." Thanks to Chris, Brian, John and Craig for offering to lead this seminar, and to council member Tim Branch for coordinating it and the rest of the symposium tax sessions.

By the time this issue of *Taxing Times* is distributed, we'll be gearing up for the Valuation Actuary (Val Act) Symposium and the annual meeting. At each meeting, the Taxation Section will sponsor a hot breakfast and two tax sessions. At the Val Act hot breakfast, John Adney and Chris DesRochers will give a Washington Update on items affecting the industry. Also at the Val Act, John and Chris will lead a workshop on Federal Income Tax Topics. The other session, Update on Statutory Deferred Tax Assets, will be led by Barbara Gold and tax accountant Martin Chotiner. The annual meeting sessions are still being finalized, but are expected to include sessions on Taxation Rules for Hedging and Company Tax Hot Topics.

The section council is grateful to all of the actuaries and Friends who have stepped up to make sure our events are timely and informative. Anyone who would like to become more involved in the section is welcome to participate as a Friend of the Council. Please contact me for details.

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

Mary Elizabeth Caramagno, FSA, MAAA, is vice president, Tax at Prudential Financial and may be reached at *maryelizabeth.caramagno@prudential.com*.

2. WHAT LED YOU TO YOUR CURRENT POSITION AT THE IRS?

I really enjoyed litigation. As a DOJ litigator, I was responsible for handling all aspects of the cases assigned to me from discovery, to brief writing, and to court appearances. I handled tax cases in the Court of Federal Claims, which is a court of national jurisdiction. My cases ranged from individual issues such as whether tax returns were timely mailed, to complex corporate issues such as whether an oil company was entitled to a credit for producing oil from tar sands. I also worked on a few insurance tax issues, including one of the last § 809 DER cases. Litigation, especially during the discovery phase, requires a lot of traveling. After I started a family, I wanted a job that would mainly let me sleep in my own home. The Office of Chief Counsel was the perfect segue for me—I could still practice tax law, but with almost no work travel. I enjoyed the insurance tax cases, and sought a position in the Insurance Branch.

3. DID YOU HAVE PRIOR EXPERIENCE WITH THE INSURANCE INDUSTRY BEFORE YOU JOINED THE INSURANCE BRANCH?

None, other than the few insurance litigation cases I worked on. It was a bit of a "leap of faith." I enjoyed the very technical nature of the insurance tax law, and my background working on Wall Street made the financial institutions and products area a good fit.

4. CAN YOU TELL OUR READERS WHAT YOUR PRINCIPAL RESPONSIBILITIES ARE?

The main function of the Insurance Branch is to interpret Subchapter L of the Internal Revenue Code, which provides the rules for insurance companies to determine their taxable income, as well as sections 72, 101, 7702, 7702A and 7702B, which provide the rules for determining taxable (or tax-exempt) income from life insurance products. We issue private letter rulings to individual taxpayers on how to determine taxes on proposed transactions. We issue technical advice memoranda to the IRS Exam personnel on legal tax issues that come up during audits of insurance companies. The Insurance Branch also facilitates closing agreements between life insurance companies and the IRS to remediate inadvertent failures of life insurance contracts to comply with sections 101, 7702 and 7702A, as well as separate accounts that are improperly diversified under section 817. We process change in method of accounting requests related to Subchapter L issues for taxpayers who discover that they have been using an improper method or wish to change to a different appropriate accounting method. The Insurance Branch participates in drafting published guidance on issues that have broad impact on insurance company taxpayers or on those who purchase insurance products. The Branch also responds to requests for Chief Counsel Advice from the IRS, responds to inquiries from Congress, and assists government litigators related to issues of taxation of insurance companies or products. As branch chief, I work on the technical issues, assign cases to the other attorneys in the branch, and deal with personnel and branch administration issues.

Sometimes, when Congress passes new tax legislation, guidance is needed to implement that legislation.

5. CAN YOU SHARE WITH OUR READERS HOW GUIDANCE IS DEVELOPED?

Guidance is worked on cooperatively among the Insurance Branch, the Office of Tax Policy and the IRS. The first step in developing guidance is to identify issues for which guidance is appropriate. Sometimes, when Congress passes new tax legislation, guidance is needed to implement that legislation. A recent example of such legislation is the Pension Protection Act of 2006 which, among many other provisions, amended the tax law for business-owned life insurance and allowed for

CONTINUED ON **PAGE 6**

the exchange of an annuity for qualified long-term care insurance or to add a rider to an annuity to provide long-term care coverage. Suggestions for new guidance come from taxpayers when new business practices or new types of products are developed. A good example of this was the request for guidance on the adoption of Actuarial Guideline 43 by the National Association of Insurance Commissioners (NAIC). The IRS also suggests guidance subjects based on audit experience.

Once an issue is designated as the subject of guidance, an Insurance Branch attorney researches the issue and makes recommendations for the scope of the guidance and the position. After consulting with others in Chief Counsel and with the Treasury's Office of Tax Policy, the branch attorney starts drafting the actual guidance (that is, the regulation, revenue ruling, revenue procedure or notice). Before the guidance is published, it must be approved by the affected divisions of the Office of Chief Counsel, the Chief Counsel, the IRS Commissioner's office and Treasury. The amount of time it takes to publish guidance depends on many factors, including the complexity of the issues and the significance of the guidance to the industry.

6. WHAT IS THE MOST INTERESTING PART OF YOUR JOB?

My favorite thing to do, which is to me the most interesting part of my job, is interacting with taxpayers and their representatives answering questions and discussing issues. In addition to opportunities for interaction in connection with rulings and other individual taxpayer matters, I get a number of opportunities to do this at American Bar Association and Federal Bar Association programs, as well as insurance member organizations such as the American Council of Life Insurers (ACLI). I've also spoken on panels for the Society of Actuaries. It is both very edifying, as well as extremely helpful, to hear from insurance company tax practitioners about emerging issues and product development. When we were working on updating the remediation procedures in 2008, we had several helpful and fascinating meetings with various interested parties. We are currently working with taxpayers on what guidance will be needed when the new Valuation Manual, adopted by the NAIC in 2012, is effective.

7. WHAT ARE THE BIGGEST CHALLENGES THAT YOU FACE IN YOUR JOB?

My biggest challenge is to ensure that all of the Insurance Branch's work is completed. Fortunately, I am privileged to work with some very talented and smart people.

8. WHAT ARE SOME OF THE KEY ISSUES THAT YOU SEE RELATED TO ADMINISTERING THE CURRENT RULES UNDER SUBCHAPTER L?

The majority of the framework of Subchapter L was enacted in 1984. The insurance industry and insurance products have changed since then, which makes administering the current rules challenging. One area that raises many difficult issues is in determining the federally prescribed reserve for life insurance products. Section 807 provides a formulaic approach to computing reserves for federal tax purposes incorporating a reserve method (generally the CRVM or CARVM), a prescribed interest rate, and a specified mortality table. Determining what method must be used for a particular product can be difficult—especially as the industry moves toward a more stochastic approach. Another challenge is distinguishing between insurance products and investment products (such as options or other derivatives). A few years ago, the branch struggled with how best to treat contracts that provided a guaranteed lifetime benefit, but were separate from the investment vehicle. After a significant amount of research and debate, we determined that these contracts were annuities for federal tax purposes.

9. ARE THERE SOME ISSUES THAT YOU FIND MORE INTERESTING THAN OTHERS?

Of course. But I must admit that there have been many times when I started working on an issue that I initially pegged as uninteresting, but as I learned more about it, I ultimately found it fascinating. For instance, when we were working on the implementation of section 101(j), which was added to the Code by the Pension Protection Act of 2006 and provides rules for when death benefits on business-owned life insurance would be tax exempt, I thought the issue of employee notification somewhat boring. But once I started to learn about the variety of real-life applications, the issue became decidedly less boring.

10. HOW ABOUT PRODUCT TAX? ARE THE CURRENT RULES FOR REMEDIATION OF FAILED CONTRACTS AND INADVERTENT MODIFIED ENDOWMENT CONTRACTS (MECS) WORKING WELL?

I find the development of new life insurance products to be very interesting, and especially enjoy working on private letter rulings establishing the appropriate federal tax treatment for new products. It's a challenging area because even if the products are developed for non-tax business reasons, tax issues are often implicated. During the process of developing the current rules for remediating failed contracts and inadvertent MECs, I learned a great deal about how complex it is for insurance companies to monitor each contract to ensure compliance with some very complex tax rules. At one meeting with taxpayer representatives, I remember a practitioner brought in a large sheaf of computer printouts. I thought the papers were a printout of contracts on a particular system, but they turned out to be the printout of a single contract's history. That was a real eye-opener for me. Ensuring compliance with the tax definition of life insurance is a very difficult job. I went into the project to update the remediation rules wondering why so many contracts failed, and came out wondering why so few failed. Because the current remediation rules were written with input from the industry, we have found them to work especially well.

11. ANYTHING ELSE THAT YOU WOULD LIKE TO SHARE WITH OUR READERS?

I am very satisfied with my work. When I became a lawyer, I didn't set out to become an expert in insurance tax. But I am very happy that I found my niche in this area. The very best part of my job is interacting with and getting to know some wonderful people working in the insurance industry.

Sheryl B. Flum is Branch 4 chief, IRS Office of Associate Chief Counsel (Financial Institutions and Products) and may be reached at *Sheryl.B.Flum@irscounsel.treas.gov.*

ACTUARY/ACCOUNTANT/ TAX ATTORNEY DIALOGUE ON NOTICE 2013-19 AND THE STATUTORY RESERVES CAP

By Edward Robbins, Mark S. Smith and Peter H. Winslow

Note From the Editor:
As we have in past issues, we are presenting a dialogue on a current life insurance company federal income tax issue, in this case the guidance issued earlier this year on the treatment of deficiency reserves with respect to the "statutory reserves cap" of Internal Revenue Code section 807(d)(1), which limits the federally prescribed reserve to be no greater than the statutory reserves for the contract. The guidance is in response to an item in the Department of the Treasury 2012-2013 Priority Guidance Plan calling for a Notice clarifying whether deficiency reserves should be taken into account in computing statutory reserves under section 807(d)(6). The discussion is among three individuals who are familiar to readers of TAXING TIMES: *Edward Robbins of Ernst & Young LLP; Peter Winslow of Scribner, Hall & Thompson, LLP; and Mark Smith of PricewaterhouseCoopers, LLP. Mark, please start us off with some background on the statutory reserves cap issue.*

Mark: The statutory reserves cap has received more attention in the past three or four years than perhaps any time since 1984. In addition to the activity related to Actuarial Guideline (AG) 43 and life principle-based reserves (PBR), which has been the subject of much discussion in these pages, on Feb. 27 of this year the Internal Revenue Service (IRS) released Notice 2013-19.[1] Notice 2013-19 concludes that the statutory reserves cap of section 807(d)(1) includes deficiency reserves, acknowledging that deficiency reserves are included in "the aggregate amount set forth in the annual statement" with respect to life insurance reserves. The fact that deficiency reserves are excluded from the federally prescribed reserve does not affect this conclusion. The Notice thus resolved an issue for which guidance had been promised for several years. We'd like to talk about that Notice, and also about the statutory reserves cap more generally. To begin, though, it would be useful to talk through some of the history of life insurance reserves and where the statutory reserves cap came from.

From 1959 to 1984, a life insurance company's taxable income was computed under a complex, three-phase system that baffled many who were not privy to the mysteries of insurance tax accounting. Ironically, one of the less complex elements of that system was the calculation of underwriting income, or at least the determination of the amount of life insurance reserves. Under the Life Insurance Company Tax Act of 1959, the starting point for computing life insurance reserves was simply the company's statutory reserves.

In 1984, Congress scrapped the three-phase system in favor of a single-phase system that bore a closer resemblance to that which applies to taxpayers in other industries. For life insurance reserves, section 807(d)(2) sets forth rules for computing a federally prescribed reserve, which is generally based on National Association of Insurance Commissioners (NAIC) prescribed valuation methods, prevailing mortality tables, and the greater of tax-prescribed or prevailing state assumed interest rates. Under section 807(d)(1), the federally prescribed reserve for a contract is bounded by a floor, which is the net surrender value of the contract, and a cap, which is the amount taken into account with respect to the contract in determining statutory reserves.

For purposes of applying the statutory reserves cap, the definition provided in section 807(d)(6) is straightforward: The term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in section 807(c), other than certain reserves attributable to deferred and uncollected premiums. Based on this definition, many believe that the statutory reserves for purposes of applying the cap, or limitation, of section 807(d)(1) are simply the statutory reserves set forth in the NAIC annual statement.

Some amounts that are included in statutory reserves with respect to a contract are explicitly not deductible in computing the federally prescribed reserve. For example, in interim guidance, the IRS asserts that the Conditional Tail Expectation (CTE) Amount of AG 43 is not included in the federally prescribed reserve for a contract under section 807(d).[2] In addition, section 807(d)(3)(C) provides that no reserve deduction is permitted for deficiency reserves, that is, amounts that arise because the net premium exceeds the actual premiums and other consideration charged for benefits under the contract.[3]

The issue, therefore, arises whether the statutory reserves cap may include a reserve amount that is explicitly not included in the federally prescribed reserve. The issue also can arise when the statutory reserves are computed on a different basis than the federally prescribed reserve.

Notice 2013-19 is deceptively simple. That is, it recites no facts, and acknowledges what most of us would have regarded as already clear based on the language of the statute and legislative history directly on point: The statutory reserves cap includes deficiency reserves. Yet, the guidance was pending for quite a long time, and I know the issue has generated considerable attention over the years, including in *Taxing Times*.[4] Peter, what issues do you see in the new Notice?

Peter: Notice 2013-19 is more notable for what it doesn't say than for what it does say. Beyond merely concluding that the legislative history requires deficiency reserves to be included in the statutory reserves cap, it does not provide useful guidance as to the factors that are important to consider for other types of reserves. Statutory reserves are defined in section 807(d)(6) as the aggregate amount set forth in the annual statement with respect to items defined in section 807(c). In its original version in the 1984 Act, this definition appeared in the now-repealed section 809 dealing with the add-on tax for mutual companies.

The definition of statutory reserves raises several important issues that we should explore in this dialogue. I can break down some of these issues into the following questions that we can discuss.

1. Are non-formulaic reserves included in statutory reserves?

2. Can aggregate or stochastically computed reserves be included and allocated back to particular contracts?

3. In determining the scope of statutory reserves, what relevance does pre-1984 Act law have as to the qualification of a reserve as an insurance reserve?

4. When is a reserve held "with respect to" a section 807(c) item?

Perhaps, the ultimate question is: What are the most important factors to consider in determining whether a liability reported on the annual statement should be included in the statutory reserves cap?

These questions should be more than enough for us to tackle.

Since the 1984 Tax Act, several types of statutory reserves have been required beyond historical deterministic net premium reserves. Ed, can you please give us some background on these non-formulaic reserves and tell us whether you think they belong in the statutory reserves cap?

Ed: Yes, you're primarily talking about "economic liability" estimates using entity-specific assumptions, commonly referred to as "asset adequacy testing" (AAT) reserves. If those economic liability estimates are greater than the formulaic reserves for those risks, the actuary is required to put up those extra amounts as reserves. Let's first give examples of those types of reserves. First came the Actuarial Opinion and Memorandum (AOM) Regulation, which required AAT for the company as a whole. The list of required AAT calculations has been growing over the years. Subsequent to the AOM requirement, several product-specific requirements have been published by the NAIC. Examples of such requirements are AG 34 (now superseded by AG 43) for guaranteed minimum death benefits, AG 38 for secondary guarantee universal life, and AG 43 for variable annuities. I would also add the gross premium valuation requirement in the health insurance statutory guidance, specifically SSAP 54. So the question of whether Notice 2013-19 will affect the ability of AAT reserves to enhance the statutory reserves cap when those reserves exceed the corresponding formulaic reserves for their respective products is an interesting one.

CONTINUED ON PAGE 10

The meaning of the flush language of Code section 807(d)(1) is the question. It specifies: "*In no event shall the [federally prescribed reserve] for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves.…*" This is a rather definitive statement, which would appear to include all statutory reserves allocable to the contract. One implication is that statutory reserves, whether or not they are part of the minimum statutory standard, or whether or not they are voluntary, strengthened, or formulaic reserves, still belong in the statutory reserves cap. Further, it would appear to include AAT reserves as well. That also appears to be the implication of the 1984 Act Blue Book language, which spoke to the inclusion of deficiency reserves.

Peter: I agree with you, Ed, that there is no reason why non-formulaic reserves should be excluded from statutory reserves for purposes of the tax reserves cap. But, there must be some basic set of principles that apply to make the determination. I believe that some of the criteria for what types of reserves are, or are not, included in statutory reserves can be found in regulations and case law interpreting pre-1984 law. Do you agree, Mark?

Mark: Well, Peter, I think the starting point requires an appreciation of just how straightforwardly Congress intended the cap to apply. Section 807(d)(6) defines "statutory reserves" for this purpose as the aggregate amount set forth in the annual statement with respect to items described in section 807(c), other than certain reserves attributable to deferred and uncollected premiums. The answer in the Code itself seems to be that the amount set forth in the annual statement is generally what governs.

Notice 2013-19 and the Committee Reports that it cites are fascinating on this point. The Report language that is cited in the Notice was written to explain provisions that *excluded* deficiency reserves from federally prescribed reserves and from the life insurance company qualification ratio. Yet, the Reports make it clear that deficiency reserves—which were not deductible life insurance reserves under pre-1984 law either—are *included* in the statutory reserves cap. For me, this is pretty strong evidence that Congress knew and intended the statutory reserves cap to mean the amounts set forth in the annual statement, period, and as a general matter not to be limited by pre-1984 law authorities.

Peter: I agree with you too, Mark. Congress must have intended statutory reserves to be a broad concept. Under the 1984 Act, statutory reserves served two functions. The excess of statutory reserves over tax reserves served to increase a mutual company's equity base, and thereby taxable income, in the add-on tax imposed by section 809, which has since been repealed. Statutory reserves also served the purpose which we are discussing now—a limitation on the amount of deductible tax reserves. For the mutual company "add-on" tax, the equity base started with statutory surplus and capital and was increased by, among other items, any excess of statutory reserves over tax reserves. Congress evidently was concerned that mutual companies would artificially reduce their equity base by reporting a portion of what otherwise could be section 807(c) reserve items as some other type of liability on the annual statement. The broad statutory language ensured that all reserves for the contract would be taken into account as long as they are connected to a deductible reserve item.

For the statutory reserves cap, an expansive definition of statutory reserves served the tax policy objective of a level playing field. Congress' goal was that all life companies should obtain comparable tax reserve deductions for the same products, but only if the company did not hold smaller reserves on its annual statement. But, to prevent an unfair result, statutory reserves were broadly defined so that the cap would come into play only where the company does not have sufficient reserves on the annual statement for the contract. That way, a company would not obtain a competitive advantage by deducting tax reserves without taking a hit to surplus. But, if a company holds sufficient reserves for the contract somewhere in the annual statement, there is no tax policy reason to give that company a smaller tax reserve deduction than its competitors.

Mark: Well, the Code requires that statutory reserves be "the aggregate amount set forth" in the annual statement "with respect to" items described in section 807(c), such as life insurance reserves. The reference to "the aggregate amount set forth" in the annual statement seems simple enough, and refers to statutory reserves. Section 1.801-5(a) of the regulations under the 1959 Act clarifies that in computing total reserves, a company is permitted to use the highest aggregate reserve "required" by any state or territory, and that the amount must be "actually held."[5] Reserves that are not required, or are not held, would presumably not pass muster.

Amounts are presumably "with respect to" items described in section 807(c) if they relate to amounts that account for obligations to policyholders. Thus, for example, contingency reserves, like the 5 percent add-on reserve in Rev Rul. 67-435,[6] are arguably not "with respect to" because they do not account for the company's obligations to its policyholders. Arguably amounts are not with respect to items described in section 807(c) if they account for a company's assets or business risks rather than its obligations to policyholders.

The complete phrase—"with respect to items described in section 807(c)"—is noteworthy for a couple of reasons. First, it suggests that a reserve need not be a section 807(c) item itself, but simply "with respect to" a section 807(c) item. Second, it appears not to be limited to section 807(c)(1) (describing life insurance reserves), but rather refers more generally to section 807(c).

I'm intrigued by Ed's observation about AAT, because this implicates all these sub-issues. Are asset adequacy reserves "with respect to" amounts described in section 807(c), or are they with respect to the company's assets and the sufficiency of those assets to meet obligations to policyholders?

Peter: There is a lot to consider in what you just said. I think that our analysis needs to start with the term "statutory reserves" and put it in the context of what Congress was trying to accomplish in the 1984 Act and how it thought the term would be interpreted in light of the state of the law at that time. Prior to 1984, life insurance companies were generally entitled to a deduction for their reserves as reported on the annual statement. They could make an adjustment under former section 818(c) for life insurance reserves computed on a preliminary term basis, and life insurance reserves had to be "required by law;" but, by and large, insurance reserves reported on the annual statement were deductible. Although the term "statutory reserves" was not in the Code prior to the 1984 Act, as a practical matter, the same concept applied.

Because the concept of statutory reserves was implicitly embedded in pre-1984 Act law, it follows that clues as to the scope of statutory reserves under current law can be found in the pre-1984 law that dealt with whether a particular reserve reported on the annual statement was deductible or not. Under pre-1984 law, a deduction generally was allowable for reserves that were properly classified as insurance reserves, but not for so-called surplus or contingency reserves or for reserves held for expenses. Whether a reserve technically qualifies as a life insurance reserve, as opposed to some other type of insurance reserve, should be irrelevant in resolving this issue because it is clear that statutory reserves is a broader concept, and because reserves that failed to qualify as life insurance reserves were still deductible under pre-1984 law if they otherwise were insurance reserves reported on the annual statement.

So, now to the hard part. Is an asset adequacy reserve or stochastic reserve in the nature of a surplus or contingency reserve or is it more in the nature of an insurance reserve? I believe the correct answer is: It depends. Some of the main factors to be considered may be found in what Ed outlined earlier—that is, the distinction between an asset adequacy reserve required by the Actuarial Opinion for the company as a whole and an asset adequacy reserve required by an actuarial guideline interpreting the Standard Valuation Law (SVL) for a particular product.

Ed: I think the answer to that question needs to consider that even many (or most) required insurance liabilities contain some provision for adverse deviation. Thus, from a purely actuarial perspective, it seems to be the ***degree*** of conservatism that can dictate whether a particular liability should be treated as a contingency item or an insurance reserve. Actuaries generally agree that a reserve should provide only for moderately adverse deviations from expectations, in order not to unduly distort statutory earnings.

Peter, to your point, whether a liability is treatable as an insurance reserve or a contingency can possibly be seen as a function of how great the degree of conservatism is. An explicit example can be found for variable annuities, in the relationship of the RBC (C-3 risk) calculation to the CTE Amount. The structure is equivalent, but the degree of conservatism is far greater in the former item. Specifically, the CTE Amount threshold is CTE 70, whereas the RBC contribution uses CTE 90. The former is a reserve, while the latter is an element of "required surplus." At the one extreme, the statutory risk-based capital (RBC) requirement could clearly be categorized as a contingency reserve by practitioners in general. Its purpose is to assure that the probability of a company insolvency is very small. It is part of statutory surplus, as opposed to being a statutory liability. The excess of total statutory surplus over a "grossed up" Company Action

At the one extreme, the statutory risk-based capital (RBC) requirement could clearly be categorized as a contingency reserve by practitioners in general. Its purpose is to assure that the probability of a company insolvency is very small.

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Level RBC is generally considered "free surplus." The RBC requirement would appear clearly to be a contingency fund. It is not a deductible liability. But, by its nature, and considering that a company not satisfying the RBC requirements will be insolvent, it could be classified as an "effective liability," despite its inclusion in company surplus.

Next down the chain might be the asset valuation reserve, which would appear to be a contingency reserve on assets, but which is part of statutory liabilities nevertheless. However, changes in the asset valuation reserve go directly to surplus as opposed to statutory earnings. It is not a deductible liability. Its nature would appear to be that of a contingency fund, and, to Mark's point, it is only indirectly (if at all) with respect to "liabilities to contractholders."

Jumping to the other extreme, statutory formulaic insurance reserves according to minimum standards are clearly includable in the statutory cap. Note that the required assumptions generally provide for some adverse deviation, as would be necessary to run a viable insurance operation. Deficiency reserves, which form part of the statutory minimum formulaic reserves, would fall into this category.

Under the Code section 807(d)(1) language, voluntary changes to formulaic reserves to increase them, such as decreases in valuation interest rates, clearly should be included in the statutory reserves cap.

Then we have various AAT reserves applicable to particular product lines. These are all "evidential" items. That is, AAT reserves are compared to their respective formulaic reserves, and only when the AAT reserve exceeds the latter does the AAT reserve become the final reserve for the product line. I would view these as insurance reserves rather than contingencies, since they purport to contain the same levels of margins on the assumptions (by and large) as do the formulaic reserves. The fact that generally current assumptions, rather than at-issue assumptions, are used for AAT reserves is not pertinent, as long as the required level of margins thereon is comparable.

The degree of conservatism is not the only issue here. AAT reserves in total are primarily calculated in the aggregate over all contracts in a product line (or, in the case of the AOM requirement, over all contracts in force in the company), as opposed to being seriatim (individual contract) calculations. The issue of allocation down to the policy level is an important one.

Mark: Although I don't disagree with anything either of you has said, I do wonder what it means to distinguish among the various reserves according to the degree of conservatism. The statutory reserves cap of section 807(d)(6) prevents a company from deducting amounts on its tax returns (as a federally prescribed reserve) that exceed the amounts the company actually set aside. Whether those amounts are conservative or not is not an issue for the statutory reserves cap, and not a matter the IRS and Treasury need to concern themselves with. What matters is whether amounts were required to be set aside, and were actually set aside, by the company. "Stat equals stat."

Of course, you are correct that reserve amounts that are determined with regard to the company as a whole, or with regard to a company's assets as opposed to its obligations to policyholders, logically would not belong in the statutory reserves cap. In fact, it would be almost unnatural to apportion those kinds of reserves contract by contract, and section 807(d)(6) requires that reserves included in the cap be "with respect to" items described in section 807(c) (that is, reserves).

But all that is different from the most basic question that Peter posed: Is a stochastic reserve in the nature of a contingency reserve, or is it in the nature of an insurance reserve? Peter's answer was: It depends. My answer is the same, although I might describe that slightly differently. It might be a matter of semantics, but the distinction between an insurance reserve and a contingency reserve is sometimes hard to draw (perhaps because even an insurance reserve accounts for an insured contingency). I would ask whether the factors that are taken into account in performing the stochastic determination are factors that are, historically, inherently part of the determination of an insurance reserve. That is, are they factors like interest rates, mortality tables, even asset values to the extent they bear on the measurement of the company's guarantees to policyholders? Are they factors that drive policyholder behavior and hence the measurement of the company's obligations under the underlying contracts? A stochastic determination that looks to the company's assets, but not to its obligations to policyholders, likely would not qualify. For me, the fact that the calculation begins on a contract-by-contract basis, or that it begins on an aggregate basis and then is apportioned contract by contract, bears no weight. I really don't understand why that difference should make a reserve ineligible for inclusion in the statutory reserves cap.

I also worry what the alternatives are. Would the IRS exclude an entire reserve—or part of a reserve—from the cap even though the entire amount was required to be set aside by the company and was part of the economic measurement of the company's obligations to policyholders? Would its actuaries attempt to bifurcate that reserve, element by element and company by company? Even if that could be done—a very big "if"—I'd be concerned whether the result would produce a clearer reflection of income than what the NAIC prescribed after years of careful study.

Peter: Let's get down to the basics. The basic characteristic of an insurance reserve is that it starts with the present value of future benefits and subtracts the expected revenue that is available to fund those benefits. In a deterministic net premium reserve calculation, the assumptions in making the reserve calculation are formulaic and fixed at issue, including the receipt of future premiums and investment income. In my opinion, a reserve will qualify as an insurance reserve if it has these basic characteristics. It can be a stochastic reserve, a gross premium reserve or a rule-of-thumb estimate, but as long as it is intended to be a liability held for the present value of future benefits less future available funding for the benefits, it should be an insurance reserve and included in the statutory reserves cap. By the way, there has been some confusion about the role of expenses in insurance reserves. There is nothing inconsistent with the nature of an insurance reserve to take into account expenses in the portion of the formula that subtracts the present value of future receipts available to fund future benefits. Expenses are an appropriate consideration as a reduction of future available funding. In a net premium calculation expenses are taken into account implicitly; there is nothing wrong with a more robust reserve method that takes expenses into account explicitly.

Ed: What about the issue of conservatism?

Peter: The issue of conservatism is tricky. Obviously, the inclusion of some conservatism does not mean that a reserve, or portion of a reserve, fails to be in the nature of an insurance reserve. Conservatism is fine. In fact, a proper insurance reserve should have an element of conservatism. Otherwise, profits would emerge upfront rather than over the period of the risk exposure, and income would not be clearly reflected. That's why the proposals for accounting for insurance contracts from IASB and FASB contain a risk margin. The key is whether the conservatism is in the assumptions used to estimate the present value of future benefits and/or is needed to reflect the proper emergence of profits or whether the reserve is held primarily for another purpose. For example, a 5 percent margin in the reserve assumptions to provide for moderately adverse conditions would be just an integral part of a basic insurance reserve, but a separate reserve equal to 5 percent of total reserves across the board imposed by a state law for solvency objectives may not qualify as an insurance reserve if the actuarial reserves held by the company otherwise satisfy the SVL and already contain an element of conservatism.

Mark: I anticipate an objection that there's little real difference between a margin for conservatism that might be inherent in a reserve calculation and a margin for conservatism that is equal in magnitude but applied across the board, independent of actuarial reserves that otherwise satisfy the SVL. In the computation of the federally prescribed reserve, I believe that Congress implicitly wrung out that conservatism in at least three respects. First, it required that mortality tables be prevailing (that is, mortality tables required by at least 26 states); Second, it required that the interest rate used be the higher of the Applicable Federal Rate or the prevailing state assumed rate. Third, it defined the relevant CRVM or CARVM by ref-

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erence to prescription by the NAIC. Thus, for all three elements—mortality tables, interest rate and methodology—the federally prescribed reserve includes safeguards against a particular state requiring excess conservatism in computing its reserves. There is no requirement for "tax equipoise" in life insurance reserves. Congress instead explicitly relied on 26-state standards as the measurement for appropriate conservatism.

With excess conservatism thus addressed in the computation of the federally prescribed reserve, the statutory reserves cap plays no role in further limiting reserves for conservatism. The statutory reserves cap merely prevents a deductible tax reserve from exceeding amounts that are set aside for regulatory purposes. The IRS and Treasury should be thankful that the regime relieves them of the responsibility for devising tax-specific reserve methodologies, a time-consuming and contentious process that on the non-tax regulatory side takes years.

But this is all very abstract. How does your analysis of conservatism apply to the real-world issues of asset adequacy reserves and the CTE Amount in AG 43?

Peter: What you are saying, Mark, is that the degree of conservatism in a reserve is not the determinative issue in deciding whether an annual statement liability is included in the statutory reserves cap. I agree, but I also agree with the basic thrust of what I think Ed is saying—the degree of conservatism is an important factor in deciding whether a liability has the characteristics of an insurance reserve in the first place. Certainly, if the NAIC or a state regulator mandates a certain level of conservatism in estimating the present value of future benefits (minus the values of funding sources) for a group of policies, then the reserve—the entire reserve—should qualify as an insurance reserve and be included in the statutory reserves cap. This should be the conclusion regardless of how conservative the mandatory assumptions may be.

The statutory reserves cap merely prevents a deductible tax reserve from exceeding amounts that are set aside for regulatory purposes.

With this consideration in mind, I think qualification of the CTE Amount in AG 43 as an insurance reserve and as part of the statutory reserves cap is clear. It meets all the criteria of an insurance reserve. Also, as part of the minimum reserve required by the NAIC to satisfy the SVL, it seems equally clear that it is held "with respect to" a section 807(c) reserve item—the basic requirement for statutory reserves in section 807(d)(6). Similarly, the asset adequacy reserve portion of AG 39 reserves should qualify. It is the only actuarially computed portion of the AG 39 reserve and, without it, there would not be a sufficient CARVM reserve in market conditions such as occurred in 2008.

An opposite conclusion could be reached for the general asset adequacy reserve that is needed to satisfy the actuarial opinion, but is not held for specific policies. This probably does not satisfy the "with respect to" requirement for statutory reserves and may not be an insurance reserve. The asset adequacy reserve required by AG 34 is a close question. You could make good arguments either way. But, because the reserve is mandated by the NAIC for a specific group of policies, it probably should be included in the statutory reserves cap.

Ed: So far we've mentioned at least two potential criteria as to whether a reserve is of deductible character: the degree of conservatism (a question of degree) or whether the reserve is "with respect to" policyholder liabilities (a possibly "brighter line"). And there are other potential such criteria. Let's examine the RBC requirement to see how it squares with these two criteria or other criteria. An RBC requirement is in part with respect to policyholder liabilities but is not deductible. It seems that the degree of conservatism is sufficiently extreme to render it non-deductible on that score. When a margin is too great, one might question whether that margin was set aside for a particular product line, or, whether it was intended to support the company as a whole.

A third criterion is simply the placement in the annual statement. The RBC requirement is not contained in either of the two annual statement reserve exhibits (Exhibits 5 and 6). Indeed, it speaks to asset issues as well as liability issues. Thus, from a technical perspective, it is not a statutory reserve at all and fails the specific test under section 807(d)(1). A fourth criterion might be the relative ease with which it is allocable down to the policy level, to enable the required contract-by-contract comparison between the federally prescribed reserve and statutory reserves.

On the other hand, let me suggest another criterion—which in fact goes the other way. Putting statutory placement aside, if a company has insufficient "Total Adjusted Capital" to cover its RBC requirement, it runs into danger of insolvency. That's a primary characteristic of a reserve. Back when Guideline 43 was first proposed, the reserve and the C-3 requirement were similar in form and different only in degree.

Peter: I believe we have identified four, and possibly five, factors so far to consider in determining whether we have a qualified statutory reserve. Let me add another question that I think should be asked, at least for asset adequacy reserves. Does the reserve arise because assets allocated to fund a block of contracts have a fair market value less than their book value? If the answer to this question is "yes," maybe we do not have an insurance reserve. Conversely, if the answer is "no," the label on the reserve is misleading because there is no asset inadequacy—something else is causing the need for an additional reserve.

Ed: Just to throw in a little "actuarialese" for a moment, "asset inadequacy" means that, for ***whatever*** reason, current assets together with future investment income and future premiums are inadequate to provide for future benefits plus expenses. A "fair value/book value" asset difference is not the only reason you can have asset inadequacy. But to your point, fair value/book value differences can certainly be a contributor to asset inadequacy, like in the early 1980s when interest rates were high enough to severely depress market values of assets. At that time many insurance liabilities were not particularly market-value sensitive and the values of the liabilities did not tend to be as interest-sensitive as the values of the assets.

Peter: You make a very interesting point of "actuarialese." I will add a bit of "lawyerese"—I can make a distinction between inadequate fair value/book value of assets and inadequate future investment income. One could argue that an insurance reserve starts from the premise that the value of assets is equal to the assets' book value and that the reserve measures the difference between the present values of future benefits and income. A deficiency in future premiums (net versus gross) in this calculation is a deficiency reserve and is included in the statutory reserves cap. A deficiency in future investment earnings (assumed versus actual) technically is not a deficiency reserve, but is similar in concept. Maybe an additional reserve for investment income deficiencies in a base deterministic reserve should be in the statutory reserves cap, along with traditional deficiency reserves, even though a reserve for fair value/book value deficiencies should not.

Ed: You appear to be carving out a new criterion to determine "what is a reserve" versus "what's better off as part of surplus" that speaks to the ***sources*** of inadequacy. You're differentiating a liability-based deficiency from the asset-based deficiency (which is really a pretty cool way to think about this issue!). Perhaps that could be a reason for differentiation of a reserve-type item from a surplus-type item (like the IMR and AVR, which are both asset-driven and non-deductible).

Peter: Only an actuary would describe this discussion as pretty cool. But, I do think we are on to something important here that relates back to a previous comment of Mark's and to the basic question of what types of reserves should be considered held "with respect to" a section 807(c) reserve item—the Code's definition of statutory reserves. Mark said that we should be looking at whether the reserve includes traditional insurance reserve factors. Now, I am building on Mark's point and saying that a reserve that is held primarily because there are deficiencies in the assumptions used to estimate the present value of future benefits over the present value of future funding sources clearly satisfies the Code's definition of statutory reserves—particularly if the reserve is mandated for a particular group of policies by the NAIC. Frankly, in my view, if a reserve meets this basic criterion, it should not fail the statutory reserves test simply because it is computed stochastically, or is difficult to allocate back to individual contracts, or is not reported with the base insurance reserves on the annual statement, or even has very conservative assumptions mandated by the regulators. These other factors may be important evidence that helps us determine the basic nature of the annual statement liability, but they are not really the ultimate question we are trying to answer.

Assuming I am correct that some aggregate stochastic reserves, like the CTE Amount and the asset adequacy portion of the AG 39 reserves, should be included in statutory reserves, what do we do about the contract-by-contract comparison that section 807(d) seems to contemplate?

Ed: Great question. There is a continuum here when we speak to AAT reserves. I agree that the AAT reserve associated with the AOM would probably be too far removed from the individual policies to easily come up with an equitable formula for such allocation. At the other extreme, there are at least

CONTINUED ON **PAGE 16**

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two product-specific NAIC actuarial guidelines that provide explicitly for such allocation: Guideline 43 and Part 8D of Guideline 38. With respect to those two allocation approaches, those guidelines attempted to provide for such allocation in a manner that was reasonably related to the exposure associated with those liabilities. For other required, product-specific AAT reserves, the guidance does not prescribe allocation methodologies.

Peter: Perhaps to accomplish the contract-by-contract allocation of aggregate reserves, we just use the same basic actuarial principles underlying AG 43 and AG 38 as guidance and allocate to specific contracts in a similar actuarially principled way. This is easy for me to say because it is the actuaries, not the lawyers, who have to figure out the best allocation method.

Mark: Actuarialese? Lawyerese? Is there such a word as "accountantese" or perhaps "taxtuary"? The application of section 807 necessarily relies on the skills of the actuary, the tax lawyer and the accountant. But whose role is what?

Let me end this discussion with several overall observations about the ideas we have been discussing.

First, much of our conversation so far has been very theoretical. There is a practical dimension to the administration of tax reserves and a limit to what the IRS can undertake. If I were (still) with the IRS or Treasury and charged with providing guidance here, I would look for approaches that employ bright lines and clear legal authority, not for issues that rely on untested legal theories or that require a high degree of human judgment to apply. The trend in AG 43 and in life PBR to rely more heavily on company-specific data and actuarial judgment does not necessarily make this harder, and certainly does not impose any greater burden on the IRS than on state regulators. In my own mind, the trend to rely more heavily on actuarial judgment argues for, not against, deferring to the annual statement for the statutory reserves cap. I'm not confident that any other approach would be administrable and still acknowledge the Congress' clear definition of statutory reserves as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)."

Second, on the most fundamental level, the IRS and Treasury will need to ask what tax policy is at stake in administering the statutory reserves cap. Is there agreement that the role of the cap is to limit the tax deduction for reserves to amounts actually held and reported on the annual statement? My own thoughts on this are pretty clear. Stat equals stat, and for this reason Peter is correct that the CTE Amount of AG 43 is included in the cap. But it really is important to ask at the outset whether the statutory reserves cap is just a limitation and, if not, what is its role? (In a sense, this is what was at stake for deficiency reserves, and the IRS and Treasury correctly recognized that the exclusion of deficiency reserves from the federally prescribed reserve did not mean that the statutory reserves cap—which is just a limitation—also had to be reduced.)

Third, how confident can anyone be that a reserve that is computed other than using an NAIC-prescribed methodology will still produce a clear reflection of income? When a reserve methodology is prescribed by the NAIC and is treated as an appropriate application of the SVL, it is hard to imagine that the tax administrator could make changes to that reserve and conclude with any confidence that it is still a comprehensive reserve methodology that produces a clear reflection of income. This is a judgment that, at least for regulatory purposes, entails a large number of professionals and a great deal of process. Some of the issues preceding AG 43 and life PBR have been a decade in the making.

Fourth, what are the broader costs of tax administration and litigation? The trend in recently decided cases in the reserve area, such as *American Financial*[7] and *State Farm,*[8] would not necessarily support broad departures from annual statement accounting for reserves, and the definition of statutory reserves in section 807(d)(6) is pretty straightforward. One would expect this at least argues for caution on the part of the government in applying the statutory reserves cap in a manner that entails significant departures from what is actually set forth in the annual statement.

A FINAL COMMENT FROM THE EDITOR

I would like to thank Ed, Peter and Mark for their thoughtful discussion. As they pointed out, many pages of *Taxing Times* have been dedicated to reserve issues, and we can expect that the discussion will continue. A recent Senate Finance Committee Staff paper commented:

> The rules governing insurance taxation have not been significantly reformed since 1986. Since then, many more insurance companies have become publicly traded. The federal government has become more active in overseeing the financial solvency of insurance companies through the Treasury Department's Federal Insurance Office and Dodd-Frank. And technology has enabled insurance actuaries to more accurately predict long-term liabilities.

The paper recommended that Congress consider adjusting the rules governing the amount of a life insurance company's reserves that are deductible to more closely align with statutory reserves the company is required to hold by state regulators.[9] Given that context, the discussions of the character of reserves with respect to the statutory reserves cap may also become important to discussions of the tax reserves themselves.

Stay tuned!

Note: The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP, PricewaterhouseCoopers LLP, or Scribner, Hall & Thompson, LLP.

END NOTES

1 2013-14 I.R.B. 743.

2 Notice 2010-29, 2010-15 I.R.B. 547. The correctness of this assertion has been the matter of some debate.

3 For a comprehensive discussion of the history and treatment of deficiency reserves for federal income tax purposes, see Christian DesRochers, "Deficiency Reserves: The Cicadas of the Life Insurance Industry," *Taxing Times* vol. 7, issue 3 (September 2011).

4 *See, e.g., id.,* Samuel A. Mitchell and Peter H. Winslow, "The Statutory Reserve Cap on Tax Reserve Includes Deficiency Reserves," *Taxing Times* vol. 2, issue 2 (September 2006).

5 *See also* Rev. Rul. 2008-37, 2008-28 I.R.B. 77 (concluding that the amount of the company's statutory reserves within the meaning of section 807(d)(6) is the highest aggregate reserve amount set forth on an annual statement pursuant to the minimum reserving requirements of any state in which the company does business).

6 1967-2 C.B. 232.

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

8 *State Farm Mutual Automobile Insurance Company v. Commissioner,* 698 F.3d 357 (7th Cir. 2012).

9 *BUSINESS INVESTMENT AND INNOVATION Senate Finance Committee Staff Tax Reform Options for Discussion April 11, 2013, 12,14.*

HOW THE SUPREME COURT DECISION ON DOMA IN *U.S. V. WINDSOR* AFFECTS LIFE INSURANCE PRODUCTS

By Mark E. Griffin

This article discusses the effects of the Supreme Court's recent decision in *United States v. Windsor, Executor of the Estate of Spyer, et al.* on the Federal income tax treatment of insurance products. This article will be supplemented in the next issue of TAXING TIMES to discuss Rev. Rul. 2013-17 and two sets of Frequently Asked Questions ("FAQs") which were released by the Internal Revenue Service after this issue went to press and which address the Federal tax treatment of same-sex spouses, registered domestic partners, and civil union partners.

On June 26, 2013, the Supreme Court decided in the Windsor case that section 3 of DOMA, defining "marriage" and "spouse" as excluding same-sex spouses, is unconstitutional. As a result, same-sex couples who are married in the District of Columbia and states that allow such unions are treated as spouses for purposed of federal law, including the Internal Revenue Code (the "Code"). Of particular interest to life insurance companies in light of the *Windsor* decision is the treatment of same-sex spouses under (1) the after-death distribution requirements in section 72(s); (2) individual retirement arrangements ("IRAs"); (3) the required minimum distribution rules in section 401(a)(9); (4) the eligible rollover distribution rules in section 402(c); and (5) the qualified additional benefit ("QAB") rules in section 7702(f)(5).[1]

THE *WINDSOR* CASE BRIEFLY

Edith Windsor and Thea Spyer were married in Ontario, Canada, in 2007. They resided in the state of New York, which recognized the marriage. Thea Spyer died in 2009, leaving property to Edith Windsor, and her estate paid $363,053 in federal estate taxes. Edith Windsor sought a refund of the estate taxes, claiming that the unlimited marital deduction under section 2056(a) applied, and the Internal Revenue Service denied the claim for refund. Edith Windsor then filed a claim for a refund in the U.S. Federal District Court for the Southern District of New York, which ruled that section 3 of DOMA is unconstitutional. The Second Circuit Court of Appeals upheld the decision. In affirming the appellate court's decision, the Supreme Court held that section 3 of DOMA is unconstitutional as a deprivation of the equal liberty of persons that is protected by the Fifth Amendment.

IMPLICATIONS FOR INSURANCE PRODUCTS

As a result of the *Windsor* decision, spousal provisions applicable to life insurance and annuity contracts that are governed by federal law apply generally to same-sex spouses. As noted above, these spousal provisions include the following:

1. The spousal continuation rules for non-qualified annuities and IRAs. In order for a non-qualified annuity contract to be treated as an annuity contract for federal income tax purposes, it must include the after-death distribution rules in section 72(s) that apply after the death of any "holder" of the contract. Section 72(s)(3) sets forth the so-called "spousal continuation rule" under which a designated beneficiary who is the deceased holder's surviving spouse can continue the contract as his or her own annuity contract. A similar spousal continuation rule applies to spouse beneficiary under an IRA.[2] These spousal continuation rules help explain why certain optional benefits, such as a guaranteed minimum withdrawal benefit, that are offered for joint lives under non-qualified annuity contracts and IRA annuity contracts, are limited to individuals who are spouses.

2. The spousal rules under section 401(a)(9). Qualified trusts under section 401(a), qualified annuities under section 403(a), section 403(b) annuity contracts, and IRAs are subject to the minimum distribution requirements under section 401(a)(9). Section 401(a)(9) and the regulations thereunder set forth a number of special rules for a designated beneficiary who is the employee's spouse.[3] The effect of these special spousal rules is to delay or reduce the amount of the required minimum distributions that must be made where a spouse is the designated beneficiary. In addition, the section 401(a)(9) regulations include special rules relating to the maximum period over which required minimum distributions must be made, and the manner in which distributions must be made under a joint and survivor annuity, where the sole beneficiary is the employee's spouse.[4]

3. Eligible rollover distribution rules. Special tax-free rollover rules apply to "eligible rollover distributions" under section 402(c)(4) that generally are made from a qualified plan, section 403(a) annuity, section 403(b) contract, or governmental section 457(b) plan. These eligible rollover distribution rules also apply to any distribution attributable to an employee that is paid to the employee's spouse after the employee's death. [5]

4. Family term coverage under life insurance contracts. Section 101(f) provides statutory rules on the taxation of the proceeds of a flexible premium life insurance contract issued prior to 1985. Section 7702 sets forth the definition of "life insurance contract" for purposes of the Code, effective for contracts issued after 1984. Each of these sections includes special rules for the treatment of a "qualified additional benefit" ("QAB"), including family term coverage (such as term life insurance coverage on a spouse). [6]

5. Certain other spousal provisions. Other provisions of the Code which incorporate special treatment for spouses include (1) the exceptions to the taxable transfer rules in section 72(e)(4)(C) and section 1041 for certain transfers to spouses or former spouses; (2) exceptions to the 10 percent penalty tax under section 72(t) for distributions under a qualified retirement plan[7] which are for medical expenses, payments pursuant to a qualified domestic relations order, distributions to unemployed individuals for health insurance premiums, distributions for higher education expenses, and distributions for first time-homebuyers; and (3) special spousal rules applicable to qualified plans under which annuities can be issued (such as the rules requiring spousal consent and spousal annuities in certain circumstances).

Prior to the *Windsor* case, many life insurance companies made it a practice to provide disclosure to contract owners addressing the implications of DOMA under their contracts. Some companies have even included provisions addressing DOMA in their contract forms or in endorsements to their contracts. Hence, companies will need to review their contracts and related materials, such as prospectuses used with variable contracts, to determine whether they might need to be revised in light of the *Windsor* case.

It should be noted that the Supreme Court expressly limited its opinion and holding in the *Windsor* case to lawful marriages under state law. In particular, the *Windsor* case does not address the constitutionality of section 2 of DOMA, which generally recognizes states' rights to define marriage and spouse, and allows states to refuse to recognize same-sex marriages entered into in other states. The case does not address whether there is a constitutional right to same-sex marriage, *i.e.*, the Court did not provide for the right to same-sex marriages in states that do not permit it.

As a result of the *Windsor* decision, spousal provisions applicable to life insurance and annuity contracts that are governed by federal law apply generally to same-sex spouses in the District of Columbia and states that recognize same-sex marriages. Because some states recognize such marriages, and others do not, life insurance companies may need to determine which state's rules apply to their contracts for purposes of administering the spousal rules that apply to their contracts. For example, some have asked whether spousal treatment applies to individuals who marry in a state that recognizes same-sex marriages (like New York) and later move to another state that does not recognize the marriage (like Florida). It will be interesting to see what action states might take with respect to this issue.[8]

It should be noted that the Supreme Court expressly limited its opinion and holding in the *Windsor* case to lawful marriages under state law.

This problem of differing state laws might be avoided with respect to employer plans that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). The provisions of ERISA generally supersede state laws as they apply to employee benefit plans.[9] Because of this pre-

CONTINUED ON **PAGE 20**

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emption, spousal provisions of an ERISA plan (such as the ERISA rules requiring spousal consent and spousal annuities in certain circumstances) can apply to same-sex spouses who are covered by the plan even if they live in a state that does not recognize same-sex marriages.

In addition, the Obama administration indicated that it intends to address this problem of differing state laws by applying spousal provisions in the federal law on the basis of where a couple weds, and not necessarily on where they live. Under this approach, a couple who is legally married in one state would be treated as married for federal law purposes even if they move to a state that does not recognize the marriage.[10] The Internal Revenue Service also indicated that it will move quickly to revise guidance in wake of the Court's decision, but no details were given on what this guidance would involve.[11]

Other questions being raised about the impact of the *Windsor* case relate to the extent to which the decision (1) has retroactive application, *i.e.,* what impact the decision might have on existing or terminated contracts, and (2) applies to state laws which extend spousal rights to domestic partners and civil union partners.◂

END NOTES

1 Unless otherwise indicated all section references are to the Code.

2 Section 408(d)(3)(C); Treas. Reg. section 1.408-8, Q&A-5.

3 Section 401(a)(9)(B)(iv); Treas. Reg. section 1.401(a)(9)-3, Q&A-3(b) and Q&A-5; Treas. Reg. section 1.401(a)(9)-5, Q&A-4 and Q&A-5.

4 Treas. Reg. section 1.401(a)(9)-5, Q&A-4; Treas. Reg. section 1.401(a)(9)-6, Q&A-2.

5 Section 402(c)(9); Treas. Reg. section 1.402(c)-2, Q&A-12.

6 Section 101(f)(3)(E); Section 7702(f)(5).

7 For this purpose, a "qualified retirement plan" is defined in section 4974(c) to mean (1) a qualified plan under section 401(a); (2) a qualified annuity under section 403(a); (3) a section 403(b) annuity contract; (4) an IRA account or annuity contract under sections 408(a) and (b); and (5) any plan, contract, account or annuity which is determined by the Secretary of the Treasury to be such a qualified retirement plan.

8 For instance, the New York State Insurance Department issued several pronouncements addressing the application of DOMA. *See, e.g.,* New York State Insurance Department, *Guidance for Filings Made to Comply with Supplement No. 1 to Circular Letter 27 (2008)* (Dec. 9, 2009) (at http://www.dfs.ny.gov/insurance/life/guidance/p_guide_cl27_2008_supp1.htm). Presumably, the department will issue new guidance in light of the *Windsor* case.

9 *See* section 514 of ERISA at 29 U.S.C. § 1144.

10 Lisa Rein and Steve Vogel, *Administration Says It Will Press to Provide Marriage Benefits in All States,* The Washington Post, June 27, 2013 (at http://www.washingtonpost.com/politics/administration-says-it-will-press-to-provide-marriage-benefits-in-all-states/2013/06/27/2f84d8e6-df5f-11e2-963a-72d740e88c12_story.html).

11 *IRS Promises Revised Guidance After DOMA Decision,* Tax Notes Today (June 28, 2013).

IRS ISSUES RULING APPLYING DIVERSIFICATION RULES TO ILLIQUID FUNDS

By Bryan W. Keene and Alison R. Peak

On March 1, 2013, the Internal Revenue Service ("IRS") released PLR 201309011, which addresses the application of the section 817(h) diversification requirements to variable contracts that have invested in illiquid investment vehicles (the "Funds"). The ruling concludes that a diversification failure will not occur as the Funds liquidate their holdings and distribute cash to their investors, even though the distributions will cause the relative values of the Funds' remaining assets to exceed the applicable asset concentration limits (*e.g.*, a single investment of a Fund might exceed 55 percent of the Fund's total value as a result of a distribution). The conclusion is based on Treas. Reg. section 1.817-5(d), which provides generally that a discrepancy with the concentration limits will not violate section 817(h) "unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition." To our knowledge, PLR 201309011 is the first ruling addressing this aspect of the regulations.

BACKGROUND ON SECTION 817(h)

Section 817(h)(1) generally provides that a variable contract will not be treated as an annuity or life insurance contract "for any period (and any subsequent period) for which the investments made by [the segregated asset] account are not … adequately diversified" in accordance with applicable regulations. The regulations provide that a segregated asset account will be considered adequately diversified only if:

(1) No more than 55 percent of the value of the total assets of the account is represented by any one investment;
(2) No more than 70 percent is represented by any two investments;
(3) No more than 80 percent is represented by any three investments; and
(4) No more than 90 percent is represented by any four investments.

A segregated asset account must meet these requirements at the end of each calendar quarter or within 30 days thereafter. With respect to new segregated asset accounts, the regulations provide a "start-up rule" under which the account is considered adequately diversified until its first anniversary. The regulations include a parallel rule with respect to a segregated asset account's "liquidation period," under which the account is considered adequately diversified for the one-year period beginning on the date a "plan of liquidation" is adopted (or a two-year period if the account is a real property account).

As described above, and pertinent to the new ruling, Treas. Reg. section 1.817-5(d) provides as follows:

> *"Market fluctuations.*—A segregated asset account that satisfies the [section 817(h) requirements] at the end of any calendar quarter … shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements *unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition."* (Emphasis added.)

If a diversification error causes a variable contract to lose its status as an annuity or life insurance contract, then absent correction through a closing agreement with the IRS the loss of status is permanent, even if the segregated asset account is adequately diversified in subsequent calendar quarters. If a contract is not treated as an annuity or a life insurance contract under these rules, the "income on the contract" is currently includible in the policyholder's gross income, *i.e.*, tax deferral on the inside build-up is lost.

FACTS

The taxpayer in PLR 201309011 is a foreign insurer that elected pursuant to section 953(d) to be treated as a domestic corporation for U.S. tax purposes. The taxpayer issues variable contracts based on "Separate Accounts." Each Separate Account invests all its assets in a corresponding Fund. Each Fund is an "insurance-dedicated" partnership, *i.e.*, it is a look-through entity under Treas. Reg. section 1.817-5(f) and therefore each Separate Account is treated as holding a proportionate share of its corresponding Fund's assets when

CONTINUED ON **PAGE 22**

applying the diversification test. The Funds invest primarily in other "Investment Vehicles," such as partnerships. The investment manager for the Funds also manages some of the underlying Investment Vehicles, but not others. The ruling refers to these as the "Affiliated Investment Vehicles" and the "Unaffiliated Investment Vehicles," respectively. The ruling does not state that the Investment Vehicles are insurance-dedicated, and it otherwise appears that they are not.

According to the ruling, the Investment Vehicles have suspended or restricted redemptions due to significant investment losses they have suffered in recent years, *i.e.*, they have become illiquid. In the case of the Unaffiliated Investment Vehicles, the redemption restrictions are beyond the Funds' control. In the case of the Affiliated Investment Vehicles, the same manager also manages the Funds, but the ruling notes that (1) the manager imposed the redemption restrictions on all investors in the Affiliated Investment Vehicles based entirely on non-tax considerations and in accordance with the manager's obligations under federal securities laws to protect all such investors, and (2) the Funds' interests in the Affiliated Investment Vehicles are *de minimis* compared to the ownership interests of the other investors.

The Funds themselves have received redemption requests, *e.g.,* as a result of variable contract owners exercising their contractual rights to reallocate cash values from the Funds to other investment options under the contracts. The Funds have been unable to meet these redemption requests due to the liquidity constraints being imposed by the underlying Investment Vehicles. This led the Funds' manager to exercise a right it possessed to suspend the Funds' obligations to fulfill such requests and initiate steps to redeem all the interests in the Funds pursuant to a "Proposed Transaction" described in the ruling.

Under the Proposed Transaction, each Fund will distribute cash to its investors (*e.g.,* the taxpayer life insurance company), including cash the Fund currently holds and cash it receives in the future from the Investment Vehicles and other Fund investments. The Funds will not use this cash to purchase other assets or increase their investments in any current holdings. The life insurance company will transfer the cash it receives in accordance with contract owners' instructions, *e.g.,* by reallocating the cash to other investment options under the contracts that are not based on the Funds. This process will continue until each Fund has redeemed all interests therein, which will occur as soon as reasonably practicable but is expected to take multiple calendar quarters.

As a result of the Proposed Transaction, the taxpayer life insurance company expects that a discrepancy may arise between each Fund's holdings and the section 817(h) diversification requirements. In particular, the ruling states that "[a]lthough neither Fund will increase or otherwise modify its non-cash holdings as part of the Proposed Transaction, each cash distribution a Fund makes will reduce its overall holdings such that the relative value of the Fund's remaining assets, expressed as a percentage of each Fund's reduced overall holdings, will increase."

EXAMPLE

The following example illustrates how a discrepancy could arise under the Proposed Transaction. Assume that, at the end of a calendar quarter, a Fund has the following assets with the following values that satisfy the percentage limitations under Treas. Reg. section 1.817-5(b):

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	55%	largest asset = 55%	55% limit = No
Asset #2	$150	15%	top 2 assets = 70%	70% limit = No
Asset #3	$100	10%	top 3 assets = 80%	80% limit = No
Asset #4	$100	10%	top 4 assets = 90%	90% limit = No
Asset #5	$100	10%		
Total	$1,000	100%		

Now assume that the Fund receives a cash payment from Asset #5 that terminates its interest therein. At that point, the Fund has the following assets with the following values that satisfy the percentage limitations under Treas. Reg. section 1.817-5(b):

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	55%	largest asset = 55%	55% limit = No
Asset #2	$150	15%	top 2 assets = 70%	70% limit = No
Asset #3	$100	10%	top 3 assets = 80%	80% limit = No
Asset #4	$100	10%	top 4 assets = 90%	90% limit = No
Cash	$100	10%		
Total	$1,000	100%		

Now assume that the Fund distributes the cash it received with respect to its prior Asset #5. If the value of the Fund's remaining assets does not change, a discrepancy will arise between the values of those assets and the percentage limits of Treas. Reg. section 1.817-5(b) at the end of the next calendar quarter, as follows:

Assets	Value (in $$)	Value (as %)	Combined % Value	817(h) Discrepancy?
Asset #1	$550	61%	largest asset = 61%	55% limit = Yes
Asset #2	$150	17%	top 2 assets = 78%	70% limit = Yes
Asset #3	$100	11%	top 3 assets = 89%	80% limit = Yes
Asset #4	$100	11%	top 4 assets = 100%	90% limit = Yes
Total	$900	100%		

As the foregoing example shows, a discrepancy with the asset concentration limits could arise merely because the Fund distributes cash to its investors. The taxpayer sought a ruling that any such discrepancy would not run afoul of section 817(h).

ANALYSIS AND CONCLUSION

The ruling summarizes the section 817(h) diversification requirements, and in particular cites to Treas. Reg. section 1.817-5(d). That regulation provides that a segregated asset account that satisfies the concentration limits as of the end of a calendar quarter will not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the concentration limits "unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition." The ruling provides the following gloss on the regulation:

> Treas. Reg. [section] 1.817-5(d) does not provide an exception to the diversification requirements of [section] 817(h). In the interests of sound tax administration, the regulation clarifies that neither holding assets in nor disposing [of] assets from a segregated asset account, which otherwise satisfied the diversification requirements at the end of the preceding calendar quarter (or within 30 days thereafter), does not give rise [sic] to a failure to meet the diversification requirements in a subsequent quarter.

The ruling then observes that, under the Proposed Transaction, neither Fund will increase or otherwise modify its non-cash holdings. As a result, (1) the anticipated discrepancies with the concentration limits "will result from the disposition [of the Funds' assets] and the related distributions to the contract-holders," and (2) "[n]o potential discrepancy will exist immediately after the acquisition of any asset [or] either wholly or partly as the result of the acquisition of any asset." Based on these observations and the facts summarized in the ruling, the IRS concludes that under Treas. Reg. section 1.817-5(d) neither Fund will fail the section 817(h) diversification requirements in the calendar quarter in which any discrepancy arises pursuant to the Proposed Transaction or in any subsequent calendar quarter.

OBSERVATIONS

The ruling addresses a difficult situation that some segregated asset accounts have faced in recent years in connection with illiquid investments—how to maintain section 817(h) diversification compliance during an extended liquidation process. As noted above, the regulations under section 817(h) also include a special "liquidation period" rule in Treas. Reg. section 1.817-5(c)(3). In general, the rule prescribes a safe harbor under which the diversification requirements do not apply at all during the specified period, allowing the account to continue acquiring assets, disposing of assets, exchanging assets, and otherwise operating without regard to the concentration limits, but only for a specified period after adopting a plan of liquidation. The ruling, in effect, would seem to facilitate a longer liquidation period by relying on the rule of

CONTINUED ON PAGE 24

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Treas. Reg. section 1.817-5(d). To be eligible for that rule, however, the account cannot acquire any new assets, and instead must limit its activity to disposing of assets and distributing the resulting cash to investors.

The ruling's conclusion under Treas. Reg. section 1.817-5(d) appears consistent with a similar rule under the section 851 diversification requirements applicable to regulated investment companies ("RICs"). Under those requirements, a RIC that is diversified at quarter-end will not lose its RIC status because of a discrepancy with the applicable concentration limits "unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition." The regulations under section 851 provide an example where a discrepancy arises due to a RIC's distributions to its shareholders, concluding that the discrepancy does not cause the RIC to lose its tax status. The facts of the ruling appear consistent with this example, in that the discrepancy with the section 817(h) concentration limits would arise as the Funds make distributions to their investors, not as a result of the acquisition of any assets.

Although the ruling endorses a potentially useful method of ensuring diversification compliance in liquidations that are expected to extend beyond the normal "liquidation period" safe harbor, the ruling includes several statements that seem to warn taxpayers against extending its reasoning to potentially aggressive transactions. For example, the ruling carefully addresses the fact that the same person manages the Funds and the Affiliated Investment Vehicles, stating that any liquidity restrictions being imposed by the latter are based entirely on non-tax reasons, *i.e.,* without an intent to circumvent section 817(h).

Likewise, the ruling addresses the fact that, although the Funds themselves will not "acquire" any new assets—a fact that was critical to their ability to rely on Treas. Reg. section 1.817-5(d)—the underlying Investment Vehicles could acquire new assets. One could envision an attempt to seize upon this distinction by structuring an arrangement so that all acquisition activity occurs within a non-insurance-dedicated fund at the lower-tier fund level, without attribution of that activity to the segregated asset account and thereby facilitating indefinite reliance on Treas. Reg. section 1.817-5(d). The ruling, however, is careful to explain that any acquisition activity by the underlying Investment Vehicles will either (1) be beyond the control of the Funds' manager, or (2) occur in the normal course of managing and liquidating the Affiliated Investment Vehicles and be limited to situations where the manager determines that it is "in the best economic interests of all investors in the Affiliated Investment Vehicles to acquire an asset in order to protect or preserve the value of existing investments or to prevent or limit losses on existing investments."

In other words, the ruling appears to demonstrate the willingness of the IRS to allow taxpayers to utilize Treas. Reg. section 1.817-5(d) in a way that effectively facilitates liquidation periods longer than the safe harbor period otherwise available, at least in situations where no gaming of the rules is involved. In other situations, the IRS may have concerns with taxpayers who try to stretch this result too far.

END NOTES

1. The ruling was issued on November 29, 2012. As used herein, the word "section" means a section of the Internal Revenue Code of 1986, as amended, or the regulations thereunder (as applicable).
2. A variable contract is defined in section 817(d).
3. Treas. Reg. section 1.817-5(b)(1)(i).
4. Treas. Reg. section 1.817-5(a)(1). A segregated asset account is defined in Treas. Reg. section 1.817-5(e) in somewhat oblique terms. As a practical matter, under the typical variable contract each variable investment option will constitute a segregated asset account within the meaning of this definition.
5. Treas. Reg. section 1.817-5(c)(2)(i).
6. Treas. Reg. section 1.817-5(c)(3).
7. Treas. Reg. section 1.817-5(a)(1).
8. Treas. Reg. section 1.817-5(a)(1). "Income on the contract" is computed using the rules of section 7702(g) and (h), applicable to life insurance contracts that do not comply with the section 7702 definition of a life insurance contract. Id.
9. Treas. Reg. section 1.817-5(f) provides that, if certain requirements are met, a segregated asset account's interest in a regulated investment company, partnership, real estate investment trust, or grantor trust is not treated as a single investment of the segregated asset account, and instead the account is treated as directly holding the assets of the entity. In other words, the entity is "looked through" when applying the diversification test.
10. For simplicity, the example assumes that the "cash" is a single investment of the Fund for purposes of the section 817(h) requirements. In reality, the cash could represent multiple investments under the section 817(h) requirements, e.g., it could be treated in part as a security issued by one or more depository institutions and in part as a government security issued by the Federal Deposit Insurance Corporation. See Treas. Reg. section 1.817-5(h)(1)(ii).
11. Section 851(d)(1).
12. Treas. Reg. section 1.851-5, ex. 5.

TAXATION SECTION SESSIONS AT THE LIFE AND ANNUITY SYMPOSIUM

By Christian DesRochers

The Taxation Section sponsored three sessions at the Life and Annuity Symposium in Toronto, Ontario on May 6 and 7, 2013. Following the symposium, the section sponsored a seminar titled "Internal Revenue Code Sections 7702 and 7702A: Introduction to the Tax Rules Affecting Life Insurance Products."

039 PD—PRODUCT TAX UPDATE

Brian G. King, FSA, MAAA, EY
Craig R. Springfield, JD, Davis & Harman LLP

In their session, Brian King and Craig Springfield covered a variety of topics related to the taxation of life insurance and annuity contracts. Among the topics covered were product tax items on the Internal Revenue Service (IRS) Priority Guidance Plan, including guidance on annuity contracts with a long-term care (LTC) rider under Section 72 and 7702B, guidance on exchanges of annuities for long-term care insurance under Section 1035 and regulations under Section 7702 defining cash values. Also addressed were the implications of the current low interest rate environment on Section 7702, and a number of recent private letter (LTR) rulings, including LTR 20123009 on the treatment of a reduction of death benefit, LTRs 201302015 and 201302016 applying Section 72(s) to joint life guaranteed lifetime withdrawal benefits (GLWBs) covering non-spouses, and LTR 201304003 applying Section 1035 to a post-death exchange of a second-to-die contract. Finally, the session addressed partial exchanges under life insurance contracts, as well as recent court cases involving lapses of life insurance contracts when policy loans are present.

With respect to annuity contracts with an LTC rider, it was observed that the current IRS position reducing the cost basis of the contract for LTC benefits is problematic for withdrawals and other distributions that occur after LTC benefits have been received, as well as withdrawals that may occur while the insured is still too chronically ill to address medical costs or other lifetime needs.

The panel also discussed expected guidance on the definition of cash value under Section 7702, tracing the development from legislative history through the 1992 proposed Regulation 1.7702-2, and more recent guidance, ending the discussion with thoughts on what the new proposed regulations might do, and whether the IRS will persist with a broad definition of cash surrender value, or a more narrow definition, as some in the industry have argued.

050—TAXATION SECTION HOT BREAKFAST: CANADA-U.S. CROSS-BORDER ISSUES FOR POLICYHOLDERS

John T. Adney, JD, Davis & Harman LLP
Philip Friedlan, JD, MBA, Friedlan Law

At breakfast, John Adney and Phil Friedlan addressed issues related to the cross-border movement of Canadian and U.S. persons, discussing the implications for taxpayers with life insurance policies. They described the differences between the Canadian Exempt test and the U.S. definition of life insurance, as well as the proposed changes in the Canadian Exempt Test Policy (ETP) limitations, which would revise the standard to an eight-pay endowment at 90, based on 3.5 percent and the 1986-1995 CIA mortality table. Unlike the current test, the revised ETP would be applied to the cash value before any surrender charge. Friedlan also discussed the proposed changes in the rules involving the deduction of loan interest on leveraged policies. Finally, the panelists addressed the Canadian and U.S. tax implications of moving between the United States and Canada, noting that Canadian policyholders who become U.S. taxpayers are subject to Section 7702 definitions. As there is no treaty relief, Canadian policies are potentially subject to tax as "failed" life insurance contracts under Section 7702. Similarly, U.S. policyholders would become subject to the Canadian Exempt test.

058—TAX POLICY, RETIREMENT AND PRODUCT DESIGNS

Christian DesRochers, FSA, MAAA, EY
Joseph F. McKeever, III, JD, Davis & Harman LLP
Kimberly W. Lunn, JD, LLM, Allstate Life
Mark S. Smith, Esq., CPA, Pricewaterhouse LLP

The panel addressed the relationship between tax policy, annuity product design and policyholder actions relative to the purchase and liquidation of annuity contracts. Taxation as an annuity was explained, with the differences between qualified and non-qualified annuities summarized. While the Internal Revenue Code does not contain a formal definition of the term “annuity,” a contract is treated as an annuity for federal income tax purposes if it is considered to be an annuity contract in accordance with the customary practice of life insurance companies, provides for guaranteed annuity payments and liquidates a fund over time.

Kim Lunn provided a historical perspective, noting the long-standing tax policy of the federal government to encourage savings through annuities, citing Abraham Lincoln’s Annual Message to Congress in 1864. She also traced the taxation of annuities, citing the evolution of annuity products, as well as the way in which they are taxed, in response to changes in social and market changes over time.

Joe McKeever summarized two case studies of recent annuity developments shaped by tax policy considerations: non-qualified payout annuities, including immediate annuities, longevity insurance and the contingent deferred annuity; and qualified plan products, including the qualified longevity annuity contracts (QLACs) and guaranteed lifetime withdrawal benefits (GLWBs) in qualified plans.

Finally, Mark Smith discussed broad principles of tax policy, including the total tax burden, horizontal equity (treating similar taxpayers in a consistent way), ability to pay and progressivity/regressivity of a particular tax or tax system. Commenting that some provisions were intended to either encourage or discourage some behaviors, Smith cited, among other things, the deduction of contributions for qualified plans, the deferral of tax on income earned in a qualified plan, and required minimum distributions and the penalty tax on early withdrawals from qualified plans. Explaining the concept of “tax expenditure,” Smith commented that any exercise in broadening the tax base necessarily begins with an examination of tax expenditures, including the exclusion from income of the cost of employer-provided health care, which is the largest single tax expenditure. The panelists discussed the inside buildup on life insurance, examining arguments for and against its classification as a tax expenditure. The panel concluded with a discussion of the development of recent guidance, noting both positive developments (contingent annuities) and challenges (annuity long-term care benefits).

INTERNAL REVENUE CODE SECTIONS: 7702 AND 7702A: INTRODUCTION TO THE TAX RULES AFFECTING LIFE INSURANCE PRODUCTS

Christian DesRochers, FSA, MAAA, EY
Brian G. King, FSA, MAAA, EY
John T. Adney, JD, Davis & Harman LLP
Craig R. Springfield, JD, Davis & Harman LLP

This day-long teaching session focused on the basic qualification requirements of IRC Sections 7702 and 7702A, and provided an opportunity for attendees from a variety of backgrounds (legal, actuarial, compliance, IT, tax and so forth) to increase their knowledge in this area. The session presented included:

- Part I: Requirements for Qualification as Life Insurance under the Internal Revenue Code
- Parts II–IV: Computing the IRC Section 7702 and 7702A Limitations:
  - Methods and Assumptions
  - Future Benefits, Death Benefits and Qualified Additional Benefits
  - Material Changes and Exchanges
- Part V: Managing Product Tax Risk

The opening session began with a discussion of the tax treatment of life insurance, and the definitional tests, describing the role of contractual benefits and statutory assumptions used to compute limitations. Part II addressed methods and assumptions, noting that the methods by which actuarial values are to be computed are not specified, but are left to the issuer of the contract. Discussions in Part II covered restrictions on actuarial assumptions (mortality, interest and expense) that are key elements in developing the definitional limitations, and noting that the interaction of contract provisions and guarantees form the basis of the actuarial assumptions and the statutory restrictions that are imposed, with differences depending upon the issue date of the contract, all intended to restrict the ability of product designers to increase the definitional limits artificially through manipulation of the assumptions. Part III covered the computational rules that provide restrictions on the benefits assumed to be funded that are also key to the operation of the definitional limits. Part IV dealt with the adjustment rules under Section 7702 that allow for changes in benefits while maintaining definitional limitations, as well as the material change rules under Section 7702A. Finally, Part V described issues related to the management of product tax risk, focusing on the challenges that insurance companies face in administering products within the requirements of the Internal Revenue Code.

THEN AND NOW

By Paula Hodges

Where were you 30 years ago? The Product Development Section of the SOA was formed in 1982, and its first newsletter was printed a year later, in October of 1983. As we approach this anniversary, I thought it would be fun to ask "What were we thinking?" when that first newsletter was printed back then. The following is a reprint of an article from the very first edition of the "News from the Individual Life Insurance and Annuity Product Development Section." I requested some assistance from the Taxation Section Council and Friends of that Council to decipher the changes between the life insurance tax environment back in the 1980s compared to today.

Then: Major changes in the IRS tax code in the 1980s dramatically impacted pricing of life insurance and annuity products. The 1980s tax code is the framework for determining what qualifies as life insurance for U.S. tax purposes . The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) dramatically impacted pricing of life insurance and annuity products. Some components of the vast amount of tax regulation that came about in the early 1980s:

- Special tax rules recognize the nature of life insurance, including federally prescribed tax reserves
- Product development reflected new company and policyholder tax limitations
- Definition of life insurance contract in Section 7702 applicable to all life insurance contracts
- Special life insurance company deduction (25 percent)
- Section 809 limiting deduction of mutual company dividends ("mutual company equity tax")
- Section 815 continuation of 1959 Act Phase III (PSA) tax on stock companies
- Section 845 expanded the authority of Treasury to examine and make adjustments to taxable income related to reinsurance contracts

Since Then: The tax code continues to be the framework for determining what qualifies as life insurance for U.S. tax purposes. New regulations have been layered on:

- Tax Reform Act of 1986 and Revenue Act of 1987
    - Eliminated special life insurance company deduction
    - Eliminated deduction of policy loan interest for individuals and limited for corporations
- Technical and Miscellaneous Revenue Act of 1988
    - Enacted Section 7702A creating modified endowment contracts
    - Introduced reasonable mortality and expense charges for 7702 and 7702A
- Revenue Reconciliation Act of 1990
    - Enacted Section 848 (the "DAC tax")
    - Imposed 20 percent haircut on UPR relating to cancellable A&H contracts
- Revenue Reconciliation Act of 1993
    - Enacted Section 197 (15-yr amortization of ceding commission)
- 1996 Tax Legislation: Small Business Job Protection Act, Health Insurance Portability and Accountability Act
    - Accelerated Death Benefits, Long-Term Care, Modified Guaranteed Annuities
    - Eliminated deduction of policy loan interest for corporations (with limited "grandfather")
- Pension Funding Equity Act of 2004

- Repeal of 809 which had limited deduction of mutual company dividends ("mutual company equity tax")
- American Jobs Creation Act of 2004
  - "Suspension" of 1959 Act Phase III (PSA) tax on stock companies
- Pension Protection Act of 2006
  - LTC-annuity combination contracts, subject to life DAC rate of 7.7 percent
  - Enacted Section 101(j), which provides requirements for corporate owned life insurance
- Principle-Based Reserves, Notices 2008-18 and 2010-29
  - Statutory deferred tax assets
  - Codification first permitted limited admissibility in 2001 – SSAP 10
  - This limited admissibility was expanded
    - Temporarily – SSAP 10R
    - Permanently – SSAP 101 – effective 2012 and later

Then: Our Product Development Section, and its newsletter, focused its research and communications primarily on the U.S. tax code, as that was the key dynamic at that time.

Now: With many more multi-national firms and jurisdictions, we need to concern ourselves with IFRS, Solvency II, ORSA, PBR, and a host of other issues. Taxes continue to be such an important topic that we now have an SOA Taxation Section devoted to that topic. The Taxation Section is seven years old and is about 850 members strong.

Then: Richard Kling—Chair of the Individual Life Insurance and Annuity Product Development Section

Now: Paula Hodges—Chair of the Product Development Section

Paula in 1980s:

Paula now:

Then: The only sure thing in life was death and taxes.

Now: The only sure thing in life is death and taxes.

The more things change, the more they stay the same.

The following is from the Oct. 21, 1983 newsletter of the "Individual Life Insurance and Annuity Product Development Section."

CONTINUED ON **PAGE 30**

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HOUSE WAYS & MEANS PASSES TAX BILL

H.R. 4065, The Life Insurance Tax Act of 1983, was approved by the House Ways and Means Committee on October 5. Action by the full House was expected the week of October 24.

H.R. 4065 is designed to raise $3 billion of annual tax revenue, 55% of mutual companies and 45% from stock companies. This compares to an estimated $1.9 billion of annual revenue expected under the 1982-1983 law.

Taxable income is computed in a manner consistent with the determination of the statutory gain from operation, with a number of adjustments. The policy reserves used to determine taxable income are CRVM reserves using the highest interest rate permitted in 26 states at the time the policy is issued. The mortality basis would be the most recent table adopted by 26 states at the time of policy issue, with a three-year grace period to phase in new tables. If the cash value of the policy exceeds this reserve, the cash value is to be used.

The deduction for policyholder dividends for mutual companies is limited. The amount of the limitation is determined by an involved process that essentially increases taxable income by a percentage of a company's surplus. The amount of the percentage used is designed to represent the difference in the averages of the ratios of gain from operations to surplus for stock and mutual companies.

> Amounts held in the policyholder surplus account as of the end of 1983 would continue in that account in accordance with the provisions of the 1959-1983 laws and would not be taxed unless withdrawn from that account.

The company's share of tax-exempt investment income is excluded from taxable income in a manner similar to the 1982-3 tax law, except that all amounts credited to policyholders, including dividends, are included in the policyholder' share. This may make investment in tax-exempt securities less attractive for life insurance companies.

A "taxable income adjustment" reduces taxable income by 25% of the amount otherwise. Thus, the marginal tax rate for most companies will be 75% of the corporate tax rate.

Companies with less than $500 million of assets receive a small business deduction of 60% of the first $3 million of taxable income, phased out at $15 million of taxable income.

The difference between the reserves under 1982-3 tax law and reserves under the proposed law, which would include any adjustment to net level reserves under Section 818©, would not be considered a reserve strengthening. Rather, a company would calculate the 1984 reserve increase under the assumption that reserves at the start of the year were computed as pre-scribed by the proposed law. Any difference between this reserve and the tax reserve held at the end of 1983 would be ignored.

Amounts held in the policyholder surplus account as of the end of 1983 would continue in that account in accordance with the provisions of the 1959-1983 laws and would not be taxed unless withdrawn from that account.

H.R. 4065 also addresses a number of issues relating to policyholder taxation. The rules defining life insurance applicable to flexible premium contracts under the 1982-3 law were modified in certain minor respects and the modified rules would apply to all life insurance contracts issued before the end of 1984.

Interest on policy loans of more than $500,000 would not be deductible. Proposals in earlier versions of the bill to include in the taxable income of a taxpayer surrendering a contract the value fo the death protection received under the contract were dropped from the current version of the bill.

H.R. 4065 would extend the limit on the amount of group life insurance which may be provided tax free to employees, to retired employees, thereby limiting the market for "retired life reserves" products. It also changes the basis for taxing holders of non-qualified annuities. The requirement that annuity payments begin before age 70 ½ would be dropped, but gains under annuities where the contractholder dies prior to annuitization would be included in the decedent's tax return rather than be taxable to the beneficiary. The exemption from the 5% penalty tax for contractholders who hold the annuity for ten years or more would be repealed.

The bill also provides for certain studies to be made. The studies will examine the level of revenue produced by the 1982-3 bill, the operation of H.R. 4065 during its first three years, the relative tax burdens on stock and mutual companies, and the effect of the tax legislation on the ability of life insurance companies to attract investment capital.

At this point, the bill is supported by the Treasury and by most stock and mutual life insurance companies. It is expected that the bill will pass the House without significant opposition. While no significant opposition is expected in the Senate, Senator Robert Dole, Chairman of the Senate Finance Committee, has indicated that he expects to hold hearings on the bill and that he plans to consider possible changes in property-casualty company taxation at the time life insurance taxation is considered. Life insurance company managements are hopeful that, in consideration of the need for timely action on life insurance taxation, Senator Dole can be persuaded to consider the two issues separately.

A more detailed summary of the proposed legislation is available. Anybody interested should write the Editor at the address listed on Page 2. The Editor is also willing to provide copies of the Bill on request, provided the number of such requests is within reason.

Editor's Note:
"Then and Now" *was first published in the June 2013 issue of* Product Matters!, *the newsletter of the Product Development Section. It is reprinted here with permission.*

ACLI UPDATE

By Pete Bautz

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NOTICE 2013-35 AND CONCLUSIVE PRESUMPTION OF WORTHLESSNESS

In Notice 2013-35, which was released on May 20, 2013, the Internal Revenue Service ("IRS") requested public comments by Oct. 8, 2013 on section 1.166-2(d)(1) and (3) of the Treasury Regulations, the "conclusive presumption" regulations. In particular, the Notice solicits comments on (1) whether changes that have occurred in bank regulatory standards and processes since adoption of the conclusive presumption regulations require amendment of those regulations; and (2) whether application of these regulations continues to be consistent with the principles of section 166 of the Code. The IRS is also seeking comments on the types of entities that are permitted, or should be permitted, to apply a conclusive presumption of worthlessness. According to the IRS, comments received will determine whether the existing conclusive presumption regulations should be revised, and the content of any such revisions.

The insurance industry is very interested in the Notice and the conclusive presumption regulations. Please recall that on July 30, 2012, the IRS released Industry Director's Directive ("IDD") LB&I-04-0712-009. The IDD instructed examiners not to challenge an insurance company's partial worthlessness deduction under section 166(a)(2) for eligible securities as long as the company complied with requirements outlined in the IDD. A question exists as to whether (and if so, how) the Notice or possible revisions to the section 166 regulations pursuant to the Notice might impact the IDD and/or future insurance company partial worthlessness deductions.

The American Council of Life Insurers ("ACLI") is working closely with its members to develop comments that are responsive to the questions raised by the IRS in Notice 2013-35.

PRINCIPLE-BASED RESERVES ("PBR")

On Dec. 2, 2012, the National Association of Insurance Commissioners ("NAIC") approved the Valuation Manual. The Manual contains details of a principle-based approach to establishing insurance company reserves. However, PBR will not be instituted until it has been adopted in 42 U.S. jurisdictions that account for at least 75 percent of written life insurance premium in the United States. Adoption requires that a state enact the Standard Valuation Model Law that was approved by the NAIC in 2009 and update its Standard Nonforfeiture Law. Despite the fact that NAIC approval of the Manual occurred very late in 2012, as of early June 2013, nine states had introduced PBR legislation, and four states (Arizona, Indiana, Rhode Island and Tennessee) had enacted legislation to implement PBR. Many more state legislatures are expected to address PBR in 2014.

Meanwhile, ACLI sent a letter in late March to IRS Chief Counsel Bill Wilkins and Treasury Assistant Secretary for Tax Policy Mark Mazur applauding the inclusion of Actuarial Guideline (AG) 43 guidance on the 2012–2013 IRS Guidance Priority Plan, but stressing the urgent need for PBR tax guidance during 2013. On May 1, 2013, ACLI submitted a letter to the IRS with its recommendations for items to be included on the 2013–2014 IRS Priority Guidance Plan. The first item included in ACLI's May 1 letter was a request for guidance on tax issues arising under PBR.

PBR was not included on the 2013-2014 IRS Priority Guidance Plan that was released on Aug. 9, 2013. Nonetheless, ACLI will continue to work with the IRS Chief Counsel's Office during 2013 and 2014 on issues relating to the tax treatment of PBR.

FOREIGN ACCOUNT TAX COMPLIANCE ACT

Since the release of the Foreign Account Tax Compliance Act ("FATCA") Final Regulations on Jan. 17, 2013, ACLI and its member company representatives have been studying the rules to identify areas where the rules are highly ambiguous or absolutely unworkable for the insurance industry. In early June, ACLI and its member company representatives met with Treasury and IRS officials to discuss these insurance industry related items in the final FATCA regulations. Government officials were receptive to the industry's concerns and appreciated the need for clarification or correction of the rules to facilitate compliance. ACLI offered suggestions for how to clarify or make the technical corrections on:

- The time for measuring cash value of contracts to determine whether they are financial accounts under the rules. We noted that under the definition of a cash value insurance contract, in Treas. Reg. §1.1471-5(b)(3)(vii), a cash value insurance contract is a contract that has an aggregate cash value greater than $50,000 "at any time during the year." We recommended that Treas. Reg. §1.1471-5(b)(3)(vii) be modified so that the cash value can be determined at the *end of* the calendar year, at the anniversary date of the contract, or *at such regular dates the participating FFI represents its policy compliance systems monitor and report value.*

- The treatment of the interest accrued on the delayed payment of a death benefit paid from life insurance and annuity contracts. We noted that an extension of exclusion from withholdable payment status was not provided for interest paid on death benefits of life insurance policies in the Final Regulations, similar to interest on accounts payable for goods and services. We requested that Treas. Reg. §1.1473-1 (a)(4)(iii) be modified so that the interest that accrues to between death and payout of death benefit is expressly carved out of the definition of a withholdable payment.

- The treatment of section 953(d) companies as Foreign Financial Institutions. We asked that section 953(d) companies, with rulings for separate account purposes to be treated as doing business within a state, be exempted from FFI status. We recommended that Treas. Reg. §1.1471-(b)(132) be modified to define such companies as U.S. persons.

- Qualification as certain term life insurance contract. We recommended that the age the insured can attain under term life contracts be increased to 100 from 90, since many insurers write annual renewable term contracts to age 95 and beyond. We also suggested that Treas. Reg. §1.1471-5 (b)(2)(ii) be modified to clarify that either stated or actual charges may be used to reduce the amount of premium which may be returned under a term contract.

- Presumption with respect to beneficiary of an annuity contract with a death benefit. The Final Regulations were responsive to ACLI's request that beneficiaries of life insurance contracts not be treated as owners of contracts and created a rule whereby financial institutions did not have to treat beneficiaries of life insurance contracts unless at the time of payment, the financial institution knows or has reason to know the beneficiary is a U.S. person. We recommended that Treas. Reg. § 1.1471-4 (c)(4)(iii)(B) be modified so that the rule for cash value life insurance contracts could be applied to annuity contracts with death benefits.

- Grandfathered life insurance contracts. ACLI asked that rules for grandfathered obligations be modified so that the existence of a substitution of an insured rider would not cause life insurance contracts to be treated as modified until such time that the rider was exercised and a new insured was actually substituted. We recommended that Treas. Reg. § 1.1471-2(b)(2)(B)(ii)(B)(2) and Treas. Reg. § 1.1471-2(b)(2)(B)(iv) be revised accordingly.

- Effective dates and insurance application processes. ACLI noted that as the industry awaits the finalization of Inter-Governmental Agreements ("IGAs") it is under increased time constraints for implementing new account procedures in time for the Jan. 1, 2014 deadline. We asked that relief be provided for contracts that are issued in 2014 but that are based on applications received and processed with respect to those contracts in 2013 while IGAs are being finalized.

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UPDATE
IRS ISSUES GUIDANCE REGARDING THE 2 PERCENT DE MINIMIS EXCEPTION UNDER IRC SECTION 162(m)(6)

By Daniel Stringham

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In a recent article titled *IRS Issues Notice 2011-02 in Connection with the New $500,000 Compensation Deduction Limit,* we reviewed Section 162(m)(6) of Internal Revenue Code (the "Code"), its potential impact upon the life insurance industry and a 2 percent de minimis exception from the harsh results associated with this new section of the Code.[1] Specifically, we noted that 162(m)(6) would not apply if certain premiums received from providing health insurance coverage were less than 2 percent of an employer's gross revenues for that taxable year, but that the Internal Revenue Service (IRS) Notice had also not provided a definition of gross revenues for this purpose. As a result, insurers were left to exercise their best judgment in applying the exception. On April 2, 2013, the IRS published Proposed Regulations under Section 162(m)(6) which, among other things, defined gross revenues for this purpose.[2] Unfortunately, as discussed below, the definition in the Proposed Regulations still requires some clarification by the IRS.

BACKGROUND

By way of background, Section 162(m)(6) was added to the Code as part of the Patient Protection and Affordable Care Act, and generally limits the deductibility of any compensation paid by certain health insurers to an individual to $500,000 per year. This provision was enacted to prevent insurance companies, and insurance executives, from profiting when millions of new customers purchased health insurance as a consequence of health care reform. The immediate concern for the life insurance industry was that Section 162(m)(6) could reach beyond traditional health insurance companies and also apply to life insurance companies with legacy health insurance business and to life insurance companies that sell relatively small amounts of health insurance or specialty insurance products. In response to inquiries from the life insurance industry, on Dec. 12, 2010, the IRS issued Notice 2011-02 that provided the 2 percent of gross revenues de minimis exception noted above and also answered many, but not all, of the questions raised by the industry.

DEFINITION OF GROSS REVENUES

The mechanics of the 2 percent de minimis test were briefly addressed when the IRS issued the Proposed Regulations in April 2013. In the Preamble, several paragraphs were dedicated to reviewing comments received about the de minimis exception but nothing was mentioned about the calculation of gross revenues, which would have been the logical place to at least provide some commentary and guidance on this important issue.[3] Instead, and without explanation, the IRS simply proposed a rule within the body of the regulation itself, which reads as follows: "In determining whether premiums constitute less than two percent of gross revenues, the amount of premiums and gross revenues *must be determined in accordance with generally accepted accounting principles*."[4]

It is reasonable to question whether the reference to "generally accepted accounting principles" is intended to be a reference to U.S. GAAP or, given that the terms are not capitalized, simply a requirement to use reasonable accounting principles when determining gross revenues. The answer to this question is critical as the results may be quite different depending upon the product portfolio of the insurance company. For example, if the measure of gross revenue is a GAAP measure, then issuers of annuities are significantly disadvantaged under the 2 percent test. This is the case because, for example, under GAAP a $100 premium for an annuity contract is accounted for primarily as a deposit, whereas statutory and tax accounting principles include the $100 in gross income.[5] As a consequence, an annuity writer (or an insurance company with an annuity business unit) with the same inflow of premiums would have a much lower 2 percent threshold than an issuer of only life insurance contracts, and thus the annuity writer would have a greater likelihood of falling within Section 162(m)(6) of the Code. Presumably, this was not the result intended by the proposed rule.

NEXT STEPS AND REQUEST FOR COMMENTS

At the May 2013 Insurance Tax Seminar of the Federal

Bar Association, an IRS official informally (and publicly) clarified that the reference to generally accepted accounting principles was not meant to refer to a U.S. GAAP measure, but instead was a reference to reasonable accounting principles.[6] While the informal guidance was helpful to the insurance industry, it is important to note that a public statement by an IRS official does not bind the IRS or provide taxpayers with sufficient legal authority to rely upon the statement. As a consequence, and given that the Proposed Regulations requested comments and/or a request for a hearing on the Proposed Regulations, it is expected that the industry will seek further clarification in the final regulations.

END NOTES

1. *See* TAXING TIMES, Vol. 7, Issue 2, May 2011 at page 38.
2. *See* Prop. Treas. Reg. § 1.162-31(b)(4)(iii)(A).
3. *See* the Preamble at Section E, De Minimis Exception.
4. *See id.* at footnote 2 (emphasis added).
5. *See* FASB ASC 944-605-25-4A, ASC 944-605-35-1 & -1A, ASC 944-80-05-1 through 05-3 and ASC 944-80-25-3.
6. *See* statements by Stephen Tackney, IRS deputy associate chief counsel (tax-exempt and government entities), in *Reaction to Health Insurance Compensation Regs Positive Overall, Tax Notes Today* (June 3, 2013).

IS THERE ANOTHER TAX RESERVES SOLUTION FOR PRE-2010 VARIABLE ANNUITIES?

By Peter H. Winslow

Life insurance companies and the Internal Revenue Service (IRS) are continuing to struggle with the tax reserve method to use for variable annuity contracts issued prior to Dec. 31, 2009. Since the adoption of Actuarial Guideline (AG) 43 effective on Dec. 31, 2009, statutory reserves for variable annuity contracts issued on or after Jan. 1, 1981, have been computed using that guideline. In Notice 2010-29,[1] the IRS provided interim guidance on tax reserve issues that arise from AG 43. As to pre-2010 contracts, the IRS Notice states: "the tax reserve method under § 807(d)(2)(A) and (d)(3) is the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43." The IRS determined that this interim guidance for pre-2010 contracts was required by I.R.C. § 807(d)(3), which defines the tax reserve method as CARVM prescribed by the National Association of Insurance Commissioners (NAIC) in effect on the date of the issuance of the contract. Although the NAIC gave AG 43 "retroactive" effect for pre-2010 contracts, the IRS considered AG 43 to represent a change from the NAIC's prior interpretation of CARVM. In such a circumstance, the IRS concluded that the Internal Revenue Code requires the NAIC's interpretation at the date of the contract's issuance to govern.

The problem with the IRS's conclusion is that, in the absence of AG 43, there is no clear NAIC guidance regarding how to interpret CARVM for variable annuity contracts that have guaranteed living benefits (VAGLB) riders. And, the IRS has not provided any additional guidance to supplement Notice 2010-29.

In the absence of IRS guidance, life insurance companies generally have adopted one of two approaches to determine tax reserves for pre-2010 annuity contracts with VAGLB. Some companies use AG 39 to compute tax reserves on the basis that it applied to the contracts at the time they were issued—at least for contracts issued after the 2002 effective date of AG 39. Other companies take a different approach. These companies do not follow AG 39 for several reasons, but primarily because, by its terms, AG 39 (as amended) specified that it would sunset no later than Dec. 30, 2009. Therefore, the argument goes, although AG 39 was prescribed by the NAIC at the date the contracts were issued, it was only prescribed for pre-2010 years. Thereafter, the NAIC specified that other guidance would become applicable. The NAIC guidance that the second group of companies follows is the general provisions of AG 33, as well as by analogy AG 34, which applied to variable annuity contracts with guaranteed minimum death benefits. This second approach has been referred to as the "hybrid method," and details of its application can be found in a TAXING TIMES article that this commentator co-authored.[2]

Each of these solutions has its drawbacks and the IRS (and companies) are having difficulty choosing which approach is better. There is an obvious problem with continuing to use AG 39 which, by its terms, sunsets specifically for those contracts to which it applies. Furthermore, using AG 39 as the tax reserve method for pre-2010 contracts is problematic because the Charge Accumulation portion of the reserve is not an actuarial calculation of CARVM that computes the greatest of the present values of future benefit streams. And, the IRS has consistently resisted permitting stochastically computed

CONTINUED ON PAGE 36

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reserves, such as was required by the asset adequacy portion of AG 39 reserves, from being included in the tax reserve method.

In light of these problems with AG 39, it would seem that the hybrid method would be a more likely approach for the IRS to endorse, but this commentator understands that the IRS is concerned that the hybrid method entails companies making actuarial judgments for which no VAGLB-specific NAIC guidance is available (*e.g.*, the asset drop and recovery assumption). The IRS may be reluctant to endorse a tax reserve method that grants flexibility to companies to determine different levels of tax reserves for comparable contracts.

There is a way out of this dilemma for the IRS because there is another option that has ample support in the statute. This approach is to say that AG 43, in fact, is the proper tax reserve method for pre-2010 contracts. How could the IRS reach this conclusion? Easy. Just follow NAIC guidance at the time the contract was issued as required by I.R.C. § 807(d)(3).

The last sentence under the heading "Purpose" in AG 33 provides as follows:

> While this Actuarial Guideline applies to all annuity contracts subject to CARVM, in the event an actuarial guideline or regulation dealing with reserves is developed for a specific annuity product design, the product specific actuarial guideline or regulation will take precedence over the Actuarial Guideline.

This sentence in AG 33, coupled with the sunset provision in AG 39, could be interpreted to mean that, at the time a pre-2010 contract subject to AG 33 was issued, the NAIC had prescribed that, if the NAIC ever replaced AG 39, the replacement method would automatically apply for contracts with VAGLB. As a result, when the NAIC adopted AG 43 and made it applicable to pre-2010 contracts, AG 43 became the tax reserve method for pre-2010 contracts under I.R.C. § 807(d)(3) by virtue of AG 33. Because AG 33 was in effect when pre-2010 contracts were issued and contemplated more specific subsequent guidance, AG 43, as the anticipated subsequent guidance, actually was the applicable NAIC method provided for in AG 33 at the time the contract was issued. This possible solution to the pre-2010 contract problem finds additional support in the Sixth Circuit's decision in *American Financial Group v. U.S.,*[3] which concluded that I.R.C. § 807(d) requires deference to NAIC guidance in determining the tax reserve method, if the NAIC guideline is merely a clarification of how CARVM applies to previously issued contracts. Adoption of this position by the IRS presumably would require supplementation of Notice 2010-29, but, after all, the Notice was just interim guidance.

Which is the best answer? Now we have plausible arguments for three tax reserve methods for pre-2010 contracts with VAGLB. Companies and the IRS: Take your pick.

END NOTES

1. 2010-15 I.R.B. 547.
2. Peter H. Winslow and Michael LeBoeuf, *How Are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?* 1 Taxing Times, Vol. 7, Iss. 2 (May 2011).
3. 678 F.3d 422 (6th Cir. 2012).

SUBCHAPTER L: CAN YOU BELIEVE IT?

By Peter H. Winslow

Author's Note:

> *As an original member of the editorial board of, and frequent contributor to,* TAXING TIMES, *I have been pleased with how it has developed. Newsletters work best when they have a mix of articles and regular columns. As of now,* TAXING TIMES *has regular columns from the editor, the chair of the SOA Taxation Section Council, and the American Council of Life Insurers (ACLI). With this edition of* TAXING TIMES, *I am starting what I hope will be a short regular column that is mostly for fun—pointing out quirks in life insurance taxation. I hope readers will enjoy it and that it will encourage others to think about volunteering to start a regular column for future editions of* TAXING TIMES.

Former I.R.C. § 818(c) permitted life insurance companies to elect for tax purposes to convert their life insurance reserves computed on a preliminary term basis to a net level premium basis using either an exact method or an approximate method. The preliminary term reserve revaluation provision was repealed by the Tax Reform Act of 1984. Nevertheless, **I.R.C. § 818(c) is still in effect. Can you believe it?**

Prior to the 1984 Act, stock life insurance companies were required to maintain a policyholders' surplus account that was built up by adding certain tax advantages, which included an untaxed portion of gain from operations, and certain special deductions for nonparticipating, accident and health, and group life contracts. Technically, these stock company tax benefits were not permanent, but instead under I.R.C. § 815 were subject to tax (the so-called "Phase III tax") when a release of some or all of the policyholders' surplus account occurred. One triggering event under I.R.C. § 815(d)(4) resulted when the policyholders' surplus account exceeded the greater of three limitations, one of which was 15 percent of life insurance reserves at the end of the taxable year. The level of the policyholders' surplus account and the amount of life insurance reserves at year-end used to be closely monitored by stock companies to ensure that the Phase III tax under I.R.C. § 815 would not be triggered.

For a variety of political reasons, I.R.C. § 815 was preserved in the 1984 Act although the policyholders' surplus account was frozen as of Dec. 31, 1983, with no subsequent additions. Current I.R.C. § 815 is somewhat ambiguous, and in certain respects contradictory, in part because I.R.C. § 815(f) incorporates by reference the Phase III tax trigger rules of repealed I.R.C. § 815(d) "as in effect before the enactment of the Tax Reform Act of 1984." What this seems to mean is that to the extent current I.R.C. § 815 can be read to impose a Phase III tax when the policyholders' surplus account exceeds 15 percent of life insurance reserves, for this purpose any life insurance reserves computed on a preliminary term basis should be recomputed to net level reserves under repealed I.R.C. § 818(c) if an election was in place. So, yes, I.R.C. § 818(c) is still in effect.

Does this matter? Not really. In the American Jobs Creation Act of 2004, I.R.C. § 815 was amended so that, for taxable years 2005 and 2006, distributions could be made from policyholders' surplus accounts and not taxed. Most stock life insurance companies took advantage of this rule and no longer have policyholders' surplus accounts that are potentially taxable under I.R.C. § 815. But, a reliable source has told me that he knows of at least one company that still has a policyholders' surplus account. Even though the Phase III tax has little continuing practical effect (except for the inattentive company), I haven't written anything about former I.R.C. § 818(c) in a long time and nostalgia got the better of me. ◀

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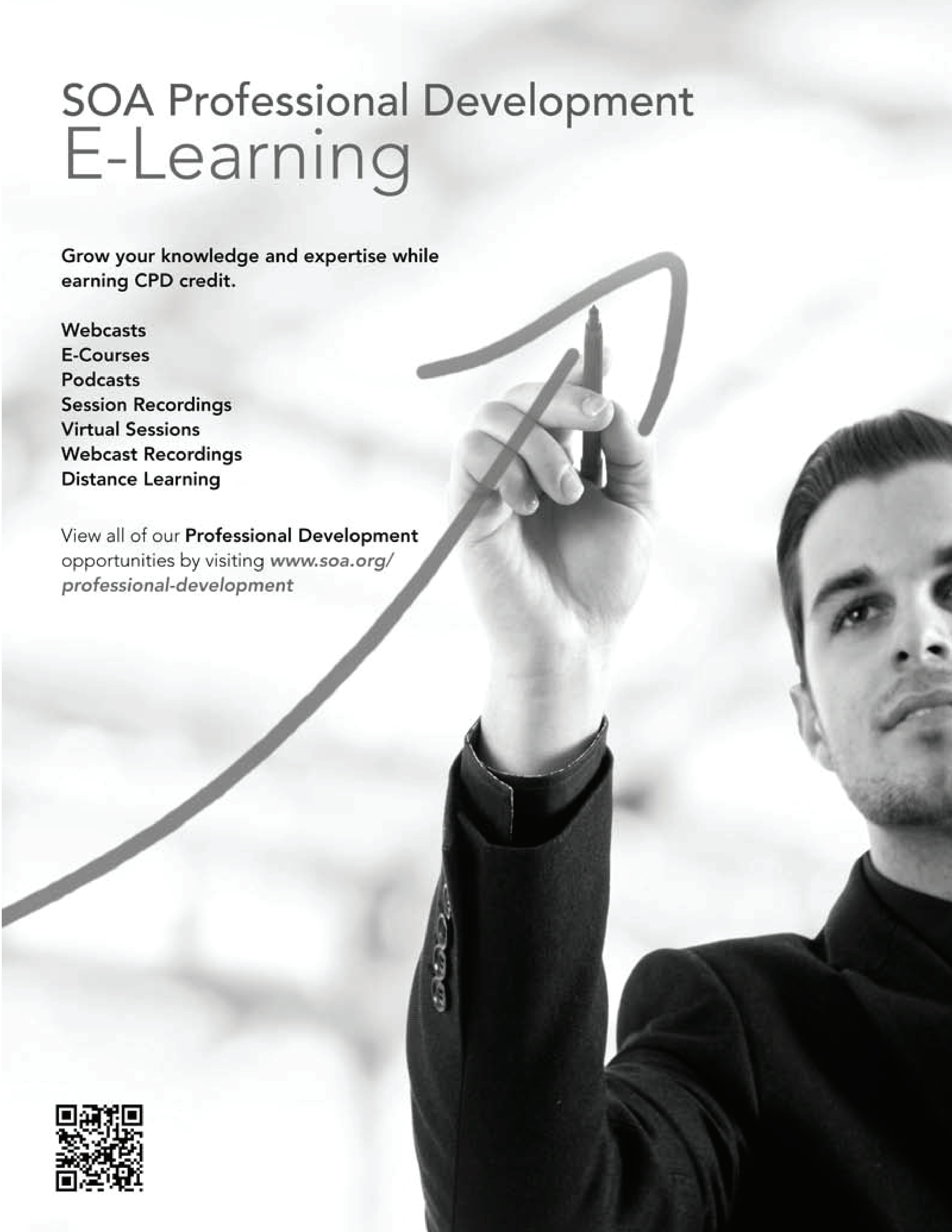
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