SOCIETY OF ACTUARIES

Article from:

Taxing Times

October 2013 – Volume 9, Issue 3

ACLI UPDATE

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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.