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IRS Notice 2016-63 – Safe Harbor Guidance for 2017 CSO

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From the Chair
Forward to 2017!

By Don Walker

As tax actuaries, looking back at the history of life insurance taxation in the United States, we can identify a number of calendar years that are engraved on our consciousness as watershed events. If your area of interest is product taxation, as mine has been, you probably have had recurring dreams (or nightmares) about 1982, 1984, and 1988. If your interest is more attuned to company tax, you put more emphasis on years that have seen major changes to the Internal Revenue Code. Recent years have been relatively quiet from our collective point of view, perhaps because of larger issues elsewhere (the Great Recession, health care) or because of divided government. But here we are in 2017, with a new administration and a possibly united government. Things may happen. Could this be a watershed year?

> … the Tax Code would probably be in play … meaningful information on potential changes could come from the Budget Resolutions …

As your Taxation Section Council met in Las Vegas at the 2016 SOA Annual Meeting & Exhibit, our focus was on what we knew then—Principle-Based Reserving (PBR) would take effect in 2017 and there would be a need for the IRS to provide guidance on how tax reserves would be impacted. We had a long discussion about the best ways to disseminate information to our members. Tentative plans were drafted for meeting sessions at the 2017 Life and Annuity Symposium, Valuation Actuary Symposium, and SOA Annual Meeting & Exhibit, as well as webinars and articles in *Taxing Times*, such as the "IRS Notice 2016-63 – Safe Harbor Guidance for 2017 CSO" article included in this edition. Since no one could be sure when the IRS would issue guidance, we would need to be flexible and ready to react quickly. Our bottom line was that PBR would be our first priority. The sidebar to this article comments on progress to date.

PRINCIPLE-BASED RESERVING

The IRS Priority Guidance Plan contains "Guidance under Sections 807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principles-based methodologies, including stochastic reserves based on conditional tail expectation." As reported in the ACLI Update column of our June 2016 issue, the ACLI specifically identified three categories of issues for guidance: (1) product qualification guidance, (2) reserve transition guidance and (3) substantive reserve guidance. ACLI singled out product qualification guidance as the most time-sensitive set of issues, and the IRS heeded this request with Notice 2016-63. IRS has not yet addressed the requests for reserve transition guidance and substantive reserve guidance.

Three weeks later, as we met for our first council call of the 2016–17 term, I asked the team (council and friends, especially our members from the tax bar) to speculate on what the results of the election would do to modify our mission for the New Year. Peter Winslow and John Adney were happy to oblige, and while they could only tell us what was making the rounds in Washington circles, they were able to give us a picture of what could happen. Briefly put, they indicated that the Tax Code would probably be in play and that meaningful information on potential changes could come from the Budget Resolutions in February/March. With this observation in hand, the council decided that we would need to be able to react just as quickly and flexibly to this possibility as we were planning to do for PBR.

I believe fervently that the primary mission of every Society of Actuaries section is education of our members. We are fortunate in the Taxation Section to have solid contacts with those in the American Academy of Actuaries who draft and comment on proposals, as well as those in the trade groups that speak for the industry and its customers. We have a section newsletter that sets the standard for a peer-reviewed digest of news and ideas. We have an alliance of actuaries and legal practitioners who work well together. And we feel that we have respect from the staff at the IRS and Treasury. As I write these words in November 2016, I am confident that we can achieve our mission in 2017.

It will be interesting! ■

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IRS Notice 2016-63 – Safe Harbor Guidance for 2017 CSO

By John T. Adney, Craig Springfield and Brian King

The Internal Revenue Service (IRS) recently released Notice 2016-63[1] providing safe harbor guidance for use of the 2017 Commissioners' Standard Ordinary mortality tables (2017 CSO) in calculations under sections 7702 and 7702A of the Internal Revenue Code, which define the terms "life insurance contract" and "modified endowment contract," respectively, for federal tax purposes. The notice's effective dates for permitted and required use of 2017 CSO generally mirror the effective dates of state law that apply for purposes of both valuation and nonforfeiture, *i.e.*, the safe harbor generally permits use of 2017 CSO for contracts issued prior to Jan. 1, 2020, but requires use of 2017 CSO for contracts issued on and after this date. The new notice generally restates the safe harbors Notice 88-128[2] and Notice 2006-95[3] and is effective Oct. 19, 2016.[4]

In an article in the October 2016 issue of *Taxing Times*, "Product Tax Implications of the Adoption of the 2017 CSO Tables,"[5] we discussed the need for IRS guidance to accommodate the development of new life insurance contracts with mortality guarantees based on 2017 CSO. In that article, we also emphasized the need for revisions to the material change rules of prior notices which address when a change in the terms or benefits of a contract will cause it to be treated as newly issued for purposes of the mortality charge safe harbors.

Notice 2016-63 provides helpful and timely safe harbor guidance for use of 2017 CSO. In this regard, insurers designing contracts with mortality guarantees based on 100 percent of 2017 CSO can be certain that use of 2017 CSO in determinations of net single premiums, guideline premiums, and 7-pay premiums under sections 7702 and 7702A will be in accordance with the reasonable mortality charge rule of section 7702(c)(3)(B)(i). Notice 2016-63 also provides useful clarifications of the material change rules, although a fundamental reconsideration of those rules continues to be needed. Regarding these clarifications, the notice provides that if the only change to a life insurance contract is a reduction or deletion of benefits, this change will not in and of itself affect the contract's issue date for purposes of the safe harbors. The notice also clarifies that a reinstatement pursuant to a contract's terms that is required by applicable state or foreign law will not cause a contract to be newly issued.

BACKGROUND

The determinations under sections 7702 and 7702A of net single premiums, guideline premiums, and 7-pay premiums for contracts issued on and after Oct. 21, 1988, generally must be based on "*reasonable mortality charges* which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is *issued*" (emphasis added).[6] Because no final regulatory guidance has been issued on reasonable mortality charges, the prevailing commissioners' standard tables establish a defined upper limit on the mortality charges that satisfy this rule. Under section 807(d)(5)(A), the "prevailing commissioners' standard tables" are the most recent commissioners' standard tables promulgated by the National Association of Insurance Commissioners (NAIC) permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued. 2017 CSO became the prevailing commissioners' standard ordinary mortality tables during 2016 when the NAIC adopted the new tables as part of the Valuation Manual under the revised Standard Valuation Law. Taking into account the three-year transition rule of section 807(d)(5)(B), the defined upper limit on reasonable mortality charges under section 7702(c)(3)(B)(i) will become 2017 CSO for contracts issued on and after Jan. 1, 2020.

While the cross-reference in section 7702(c)(3)(B)(i) to the prevailing commissioners' standard tables offers a degree of certainty with respect to the mortality charge assumption that is permissible, considerable uncertainty remains due to the requirement that mortality charges also be "reasonable." This reasonableness requirement could apply to further reduce the mortality charges that may be taken into account under this statutory rule.[7] It is uncertainty regarding the potential application of this reasonableness requirement, and the severe consequences that could result from a violation, that give rise to the need for safe harbor protection.

In addition to the general question regarding how the "reasonableness" requirement will be applied, a further issue addressed by the various IRS notices on the reasonable mortality charge rule regards the circumstances when a change in the terms or benefits of a contract would cause it to be treated as newly issued for purposes of the notices. Because the reasonable mortality charge rule's application—and thus the identification of the prevailing commissioners' standard table—is based on the issue date of a contract, a change that causes a contract to

be newly issued could cause the contract to become subject to a new prevailing table. If this consequence is not recognized and accounted for by an insurer, the determinations under sections 7702 and 7702A could be erroneous, and failures to comply with one or both of these statutes could be the result.

As discussed in detail in our prior *Taxing Times* article referenced above, it is highly questionable whether new issue treatment is appropriate in situations where a change does not result in new contract treatment under applicable law, especially in that both section 7702 and 7702A contain specific adjustment mechanisms that address the effect of a change in a contract's terms or benefits. Notice 2016-63 does not address this general concern, although as mentioned above (and as discussed further below) the new notice helpfully addresses two specific criticisms that had been raised with respect to prior IRS notices on the reasonable mortality charge rule.

NOTICE 2016-63

Notice 2016-63 restates the safe harbors established by Notice 88-128 and Notice 2006-95, and it generally retains the structure and rules of the latter notice, *e.g.*, the rules for use of unisex/sex-distinct mortality tables and for unismoke/smoker-distinct mortality tables. Most significantly, Notice 2016-63 provides a new safe harbor for 2017 CSO, stating that:

> A mortality charge with respect to a life insurance contract will satisfy the requirements of § 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after December 31, 2019, or (b) the contract is issued before January 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.[8]

With respect to the material change rules that apply for purposes of determining a contract's issue date, Notice 2016-63 also generally retains the structure and rules of Notice 2006-95. Thus, for purposes of the notice, contracts that are received in exchange for existing contracts will generally be treated as new contracts that are issued on the date of the exchange.[9] Also, similar to Notice 2006-95, the new notice provides that a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, and mortality and expense charges) are the same as the terms of the contract prior to the change.[10] Further, section 5.02 of the notice continues the prior rule, with modifications to take account of 2017 CSO, under which:

> if a life insurance contract satisfied [a safe harbor of the notice] when originally issued, a change from the previous tables to the 2001 or 2017 CSO tables is not required if: (1) the change, modification, or exercise of a right to modify or add benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 or 2017 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank.[11]

The latter two requirements under this rule pertain to whether a contract is new under applicable law, which is relevant to the applicable law requirement of section 7702(a). The first requirement relating to whether a change is "pursuant to the terms of the contract," however, appears to go beyond the statute, and as articulated in our earlier article, seems to raise questions about the tax policy purpose of the requirement. There is no reason, for example, why a change in mortality charge guarantees to reflect a change in the insured's rating or smoking status should affect a contract's issue date, regardless of whether the policyholder had a contractual right to insist upon such a change. It is hoped that the IRS will reconsider the need for the "pursuant to the terms of the contract" requirement in more permanent future guidance that more readily accommodates changes in the prevailing mortality tables.

As noted, however, Notice 2016-63 makes two significant and helpful modifications relative to the material change rules of Notice 2006-95. The first helpful modification is that the notice provides that if the only change to an existing contract is a reduction or deletion of benefits provided under the contract, this change will not affect the contract's issue date that applies for purposes of the notice's safe harbors.[12] Thus, for example, if a life insurance contract does not provide any contractual right to reduce or decrease benefits (which, for example, is common with respect to the face amount of death benefit under ordinary whole life insurance contracts), and the insurer now decides to permit such reductions or decreases, such a change will not result in new issue treatment of the contract for purposes of the notice.

The second helpful modification is provided in the examples which illustrate the operation of section 5.02 of Notice 2016-63. In particular, the notice now provides that the "changes, modifications, or exercises of contractual provisions referred to in section 5.02 of this notice include ... reinstatement of a policy within 90 days after its lapse or *reinstatement of a policy as required under applicable state or foreign law*" (emphasis added).[13] This emphasized language was not included in Notice 2006-95 and is helpful in that it removes a possible implication that exercises of contractual rights as required by applicable law to reinstate benefits beyond the 90-day period referenced in the prior notice could result in new issue treatment. Of course, as with the prior notice, since the operative rule is set forth in section 5.02 of Notice 2016-63, and section 5.03 of the notice merely offers examples, it appears that the exercise of a contractual right that satisfies the standards of section 5.02 of the notice would likely not result in new issue treatment, even if the transaction is not listed among the examples in section 5.03 of the notice.

CONCLUDING THOUGHTS

As noted above, Notice 2016-63 provides timely and helpful guidance that will assist taxpayers in transitioning to 2017 CSO. This is especially the case since it has been and remains important that the IRS provide safe harbor protection for standard-risk life insurance contracts in advance of the effective date for use of a new prevailing mortality table. The notice also provides helpful clarifications regarding the effect of benefit reductions and reinstatements for purposes of the notice's material change rule. We continue to encourage the IRS to reconsider the material change rule fundamentally since we think it serves little or no tax policy purpose and creates substantial administrative burdens, but given the time constraints involved, Notice 2016-63 offers much-appreciated interim assistance as more permanent guidance is considered. ■

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

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ENDNOTES

1 2016-45 I.R.B. 683.

2 1988-2 C.B. 540.

3 2006-2 C.B. 848.

4 Notice 2016-63 § 8.

5 *TAXING TIMES*, vol. 12, no. 3 (Oct. 2016).

6 Section 7702(c)(3)(B)(i) (pertaining to the guideline single premium). *See* also section 7702(b)(2)(B) (incorporating this rule for purposes of the net single premium under the cash value accumulation test); section 7702(c)(4) (incorporating this rule for purposes of the guideline level premium); and section 7702A(c)(1)(B) (incorporating this rule for purposes of the 7-pay premium).

7 An alternative mortality charge rule, colloquially referred to as the "TAMRA interim rule," generally allows for reflection of mortality charges which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristics of the insured of which the company is aware). *See* section 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647.

8 Notice 2016-63 § 4.04.

9 Notice 2016-63 § 5.01.

10 *Id.*

11 Notice 2016-63 § 5.02.

12 *Id.* This effectively reverses the holding in PLR 201230009 (Jan. 30, 2012).

13 Notice 2016-63 § 5.03.

In the Beginning… A Column Devoted to Tax Basics
Tax DAC

By Stephen Baker

In many accounting frameworks, insurance companies are required to capitalize policy acquisition costs rather than expensing them in the year they were incurred. This article will discuss the complexities of such a simple statement as well as highlight certain differences between tax and book treatment of that capitalization. Due to the deferral of the expense, the capitalized policy acquisition costs are often referred to as "deferred acquisition costs" or "DAC" for federal income tax purposes.

TAX GENERAL RULE

Internal Revenue Code[1] (the Code) Section 848 requires insurance companies to capitalize specified policy acquisition expenses and deduct them ratably over a 120 month period beginning with the first month of the second half of the tax year. This one sentence is pregnant with defined terms and the need for significantly more information.

TO WHAT SHOULD THE COMPANY APPLY THE DAC RULES?

Specified Policy Acquisition Expenses

The DAC rules use specified policy acquisition expenses as a proxy for the actual costs incurred. Specified policy acquisition expenses are defined as the amount of general deductions (for any taxable year) that do not exceed a percentage of net premiums on specified insurance contracts.

Specified Insurance Contract

Section 848(e)(1) provides both a definition of and exceptions to the term "specified insurance contract." The basic definition "…is any life insurance, annuity, or non-cancellable accident and health insurance contract (or any combination thereof)." This is further refined through a series of exceptions and definitions. Guaranteed renewable life, accident, and health insurance contracts are treated in the same manner as non-cancellable life, accident, and health insurance. The following contracts are excluded from the term "specified insurance contract:" any pension plan contract, flight insurance contract, qualified foreign contract [this is a defined item not included in this discussion], Archer MSA, and health savings account.[2]

HOW MUCH DOES THE COMPANY TREAT AS DAC?

Proper computation of DAC requires further clarification of three key items: (1) the definition of "general deductions," (2) the percentages used to limit the capitalization amount, and (3) the definition of "net premiums." General deductions are the itemized deductions and qualified deferred compensation.[3] The percentage used in calculating specified policy acquisition expenses varies by specified insurance contract type and is shown in Table 1. Net premiums will be discussed later in this article.

Table 1
DAC Percentage by Contract Type

Annuity Contracts	1.75% of net premiums
Group Life Insurance Contracts	2.05% of net premiums
Other Contracts Not Described Above	7.70% of net premiums

Example 1 visualizes the above. In this example Sample Insurance Company (SIC) underwrites a variety of policies. Table 2 provides the contract type, net premium amount, and capitalization percentage and amount.

Example 1.

Table 2

Contract Type	Net Premiums	Capitalization %	Capitalized Amount
Annuities	100,000	1.75%	1,750
Individual Life	200,000	7.70%	15,400
Group Life	150,000	2.05%	3,075
Non-cancellable A&H	50,000	7.70%	3,850
Total	500,000		24,075

Several types of contracts receive special treatment for purposes of selecting the appropriate DAC percentage. Each is described below.

- Reinsurance: treated in the same manner as the contract it reinsures.
- Group life contracts: the Treasury Regulations[4] provide a significant set of requirements to qualify for this lower percentage. The scope of these requirements is beyond the purview of this article.
- Annuity combined with non-cancellable accident and health insurance: treated entirely as a non-cancellable accident and health contract, subject to the 7.7 percent rate.
- Annuity or life combined with a qualified long-term care insurance contract: treated entirely as the "other contracts" classification, subject to the 7.7 percent rate.
- Other combination contracts: If the company separately states the premium for each type of coverage on its annual statement, then the premium allocable to each type of coverage is as if that portion of the contract were issued separately. If the premium is not separately stated, the entire premium is subject to the highest capitalization percentage of the coverage provided. A de minimis rule does apply, providing that if the premium attributable to one type of coverage is equal to or less than 2 percent of the entire contract premium, that type of coverage does not determine the capitalization percentage applicable to the contract as a whole.[5]
- New categories: Congress has reserved the right for the Secretary of Treasury to specify a new, separate category if certain conditions are met, but no such regulations have been issued.

Example 2.

In this example, SIC underwrote a few combination contracts. Contract 1 combines an annuity and long term care product. As discussed above, this leads to a costly result. Contract 2 combines a group life policy with a non-cancellable disability coverage. Contract 3 combines an annuity product with a cancellable accident product. Cancellable accident is not subject to DAC. In each case, the premiums for the different types of coverage are stated separately on SIC's annual statement. Table 3 provides the illustration.

Table 3

Policy Type	Net Premiums	Capitalization %	Capitalized Amount
Contract 1			
Annuity	250,000	7.70%	19,250
LTC Rider	150,000	7.70%	11,550
Total Contract 1	400,000		30,800
Policy Type	**Net Premiums**	**Capitalization %**	**Capitalized Amount**
Contract 2			
Group Life	200,000	2.05%	4,100
Non-Cancellable Disability	200,000	7.70%	15,400
Total Contract 2	400,000		19,500
Policy Type	**Net Premiums**	**Capitalization %**	**Capitalized Amount**
Contract 3			
Annuity	200,000	1.75%	3,500
Cancellable Accident	200,000	0.00%	0
Total Contract 3	400,000		3,500

Net Premiums

As noted above, DAC is determined in reference to net premiums. Net premiums are defined as the gross amount of premiums and other consideration on insurance and annuity contracts minus return premiums and reinsurance costs incurred on such contracts.

Gross premiums include the following items applicable to insurance and annuity contracts: advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer and the amount

of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies.

Several items are excluded from the definition of gross premiums:

- Deferred and uncollected premiums.
- Amounts that are effectively paid to the policyholder and immediately returned to the insurance company as a premium on the same contract, including items such as dividends and partial surrenders.
- Premiums waived as a result of the disability of an insured or the disability or death of a premium payor.
- Amounts treated as premiums when a policyholder or beneficiary selects a settlement option for receiving death benefits.
- Amounts received or accrued from a guaranty association relating to an insurance company that is subject to insolvency or similar proceedings.

Return premiums do not include the following:

- Policyholder dividends.
- Claims or benefits payments.

Also, amounts relating to reinsurance agreements are not included in gross premiums or return premiums but are instead included as part of "net consideration" for a reinsurance agreement, discussed next.

Reinsurance

The most important thing to remember about DAC for reinsurance agreements is that "net consideration" is a very broad term. Net considerations include reinsurance premiums, ceding commissions, and expense allowances, as you might naturally expect, but they also include items such as claim payments, experience rating adjustments, modified coinsurance reserve adjustments, and even loan transactions relating to funds-withheld reinsurance.

The ceding and assuming companies must treat amounts arising from reinsurance consistently in determining net premiums. For example, if the ceding company reflects –100 of net reinsurance considerations, the assuming company must reflect +100. This can involve significant coordination between the parties and typically involves making an election to ignore the "general deductions" limitation—that is, agreeing in the reinsurance treaty that both parties will capitalize based on the specified percentages even if that results in more expenses being capitalized in a year than were actually incurred.

There is a current industry discussion surrounding the capitalization of reinsurance ceding commissions. This discussion is beyond the purview of this article.

Unless an election is made, an insurance company may not reduce its net premiums with respect to premiums paid to a party not subject to U.S. taxation. The Treasury Regulations[6] provide guidance on the relevant definitions and election guidance. The amount of detail exceeds the purpose of this article.

Negative Net Premiums (Negative Capitalization Amount)

A negative net premium amount for any category of specified insurance contracts is labeled a "negative capitalization amount" and is subject to specific application. The negative capitalization amount first reduces (not below zero) the capitalized amount for the same tax year for any of the other categories. Should a negative capitalization amount still remain, this amount will reduce (not below zero) the unamortized balance as of the beginning of the tax year, of amounts capitalized under the general rule, creating a deduction in the current year. If there is still negative capitalization amount that has not been applied after these two steps, the remainder may be carried forward to future years.

WHAT IS THE AMORTIZATION PERIOD?

As a general rule, capitalized acquisition costs are deducted ratably over 120 months. The amortization period begins with the first month of the second half of the taxable year. For calendar year taxpayers, this results in 50 percent of a whole year amount being amortized in years 1 and 11, rather than amortization and calendar years being congruent.

Table 4

Tax year	Specified policy acquisition expenses in the tax year	Portion subject to 5-year amortization period	Portion subject to 10-year amortization period
2012	7,000,000	5,000,000	2,000,000
2013	9,500,000	5,000,000	4,500,000
2014	14,000,000	1,000,000	13,000,000
2015	15,000,000	-	15,000,000

Insurance companies are entitled to a five year (60 month) amortization period with respect to the first 5 million dollars of specified policy acquisition expenses. However, this more favorable amortization is phased out to the extent that policy acquisition expenses exceed 10 million dollars. In addition, all members of a controlled group are treated as one company for purposes of the phase out, and the five year amortization period does not apply to amounts attributable to reinsurance contracts.

Table 4 illustrates the application of the amortization periods to hypothetical amounts of capitalized acquisition costs.

The paragraphs above have described the tax aspects of DAC. The remainder of this article highlights a certain item that often frustrates the practitioner: the differing treatment under statutory and GAAP reporting to create the need to understand three sets of rules for the same thing.

ECONOMIC EFFECT OF CAPITALIZATION AND AMORTIZATION

The impact of Tax DAC is to defer the deduction for the amount capitalized (net of initial year pro-rata amortization), and then to recognize the deductions in subsequent years as amortization occurs. Over the course of the period, the taxable income is unchanged, but the timing of taxable income has been accelerated.

COMPARISONS AND CONFUSION

Statutory

Statutory Accounting Treatment [Annual Statement Accounting] is provided for in the Statements of Statutory Accounting Principles (SAP). SAP 71 provides guidance on the statutory treatment of acquisition costs. As a general rule acquisition costs and commissions are expenses as incurred. This varies from the mandatory capitalization (deferral of deduction) for the same costs under the tax rules.

GAAP

Rules for Generally Accepted Accounting Principles (GAAP) are discussed in the Accounting Standards Codification (ASC). DAC is specifically discussed in ASC 944-30. Policy acquisition costs are required to be capitalized based upon a different classification system than used in tax. Capitalization rules vary upon whether a contract is a short-duration, long-duration or reinsurance contract. A detailed discussion of the GAAP rules is not within the scope of this article but a few pertinent items are presented.

- GAAP focuses on the actual upfront costs involved in acquiring new contracts whereas Tax DAC capitalizes a flat percentage of first-year and renewal premiums alike.
- GAAP does not capitalize several types of acquisition costs (for example recurring costs) whereas Tax DAC begins with the view to all costs.
- GAAP amortization periods vary with the type of contract whereas all Tax DAC uses the same period.
- GAAP amortization schedules are developed using actuarial models that are based on the characteristics of the underlying business whereas Tax DAC is amortized on a straight-line basis.
- GAAP requires subsequent measurement and possible adjustment compared to the Tax DAC concept that the amortization is measured and set when the premium is received. ■

This article represents the opinion of the author only and does not represent any opinion of his employer or affiliates.

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ENDNOTES

1 Unless otherwise noted, all references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

2 IRC Section 848(e)(1)(B) and Treas. Reg. Section 1.848-1(b).

3 A detailed listing of these items is beyond the scope of this article. The general deductions are defined as those in Part VI of Subchapter B (Itemized Deductions) and Part IV of Subchapter D (Qualified Deferred Compensation) of the Code.

4 Treas. Reg. § 1.848-1(h).

5 Treas. Reg. § 1.848-1(g).

6 Treas. Reg. § 1.848-2(h).

IRS Provides Relief for Late Rollovers with New Self-Certification Procedure

By Michael Byro

An IRA owner or qualified plan participant may avoid the taxation of an IRA or plan distribution by rolling the distribution over to an IRA or qualified plan within 60 days. On Aug. 24, 2016, the Internal Revenue Service (IRS) published Revenue Procedure (Rev. Proc.) 2016-47, 2016-37 I.R.B. 346, establishing a self-certification procedure for rollover contributions that missed the 60-day deadline. The procedure allows a taxpayer to certify that a late rollover is eligible for waiver of the 60-day rollover requirement so that an insurance company acting as a qualified plan administrator or an individual retirement arrangement (IRA) trustee, custodian, or issuer (hereinafter "financial institution") may accept and report the rollover contribution without the necessity of a private letter ruling (PLR) from the IRS. The IRS intends this new procedure to provide taxpayers who inadvertently miss the 60-day deadline an easier method to complete a desired rollover.[1] But, as is common with even the best-intentioned solutions, the new IRS guidance leaves some open questions and concerns for financial institutions accepting late rollover contributions through self-certification.

This article discusses the general rules applicable to rollovers and the self-certification procedure outlined in Rev. Proc. 2016-47. It concludes with a consideration of the implications this new procedure has for taxpayers and financial institutions.

THE ROLLOVER RULES

The Internal Revenue Code (the Code) provides that a distribution from a qualified plan or IRA can be excluded from income if it is rolled over to another qualified plan or IRA within 60 days of the date it was received.[2] A financial institution must report rollover contributions to an IRA on IRS Form 5498.[3]

In 2001, the Economic Growth and Tax Reconciliation Act amended the Code, giving the IRS the authority to grant hardship waivers of the 60-day rollover requirement "where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control" of a taxpayer.[4] As this Code provision did not include sufficient explanation of the circumstances constituting a qualifying hardship or the means that a taxpayer could seek a waiver, the IRS published Rev. Proc. 2003-16, 2003-1 C.B. 359, to provide clarification. Rev. Proc. 2003-16 requires a taxpayer to apply for a hardship exception through the PLR procedure.[5] To determine whether a waiver is appropriate the IRS will consider all relevant facts and circumstances, including: "(1) errors committed by a financial institution; (2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error; (3) the use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and (4) the time elapsed since the distribution occurred."[6] In addition, Rev. Proc. 2003-16 provides an automatic waiver of the 60-day rollover requirement without a letter ruling if (1) the rollover contribution is deposited into an eligible retirement plan[7] within one year from receipt of the funds, and (2) if not for a financial institution error, the rollover would have been valid.[8]

> [S]elf-certification may be completed at no cost, unlike a PLR, and provided to the receiving qualified plan or IRA instead of the IRS.

In conjunction with the guidance in Rev. Proc. 2003-16, the IRS established a reduced filing fee schedule for taxpayers requesting a hardship waiver of the 60-day rollover requirement.[9] In 2016, however, these reduced fees were eliminated and a taxpayer requesting a 60-day rollover requirement waiver must now pay the general $10,000 fee for a letter ruling.[10]

NEW SELF-CERTIFICATION PROCEDURE

Rev. Proc. 2016-47 establishes a self-certification procedure for plan participants and IRA owners to make late rollover contributions to a qualified plan or IRA. If a taxpayer meets the necessary conditions below, the self-certification may be completed at no cost, unlike a PLR, and provided to the receiving qualified plan or IRA instead of the IRS. A financial institution may choose to, but is not required to accept a late rollover through self-certification.

Conditions for Eligibility

To be eligible for self-certification, a late rollover contribution must satisfy three requirements. First, the IRS must not have

previously denied a waiver request for the rollover. Second, the 60-day deadline must have been missed for one or more of the following reasons:

- An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
- The distribution, having been made in the form of a check, was misplaced and never cashed;
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
- The taxpayer's principal residence was severely damaged;
- A member of the taxpayer's family died;
- The taxpayer or a member of the taxpayer's family was seriously ill;
- The taxpayer was incarcerated;
- Restrictions were imposed by a foreign country;
- A postal error occurred;
- The distribution was made on account of a levy under § 6331 and the proceeds of the levy have been returned to the taxpayer; or
- The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Lastly, the rollover contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed above no longer prevent the taxpayer from making the contribution. Rev. Proc. 2016-47 includes a safe-harbor, deeming this final condition satisfied if the rollover contribution is made within 30 days after the reason or reasons no longer impede the rollover.

If the aforementioned conditions are satisfied, a taxpayer may provide a written certification to the financial institution. A model letter that may be used for self-certification is included in the Appendix of Rev. Proc. 2016-47. The self-certification procedure is effective as of Aug. 24, 2016. The IRS modified Form 5498 and its instructions to require financial institutions with IRAs to specifically report rollovers accepted after the 60-day deadline.[11]

Effect of Self-Certification

The self-certification procedure cannot be used for any purposes other than determining if a late rollover satisfies the conditions for waiver of the 60-day deadline. A financial institution may rely on a taxpayer's self-certification, but is not required to accept a late rollover.[12] A financial institution is explicitly prohibited from relying on a self-certification if it has actual knowledge that is contrary to the self-certification.

While a self-certification may be used by a taxpayer to report a late rollover contribution as a valid rollover, it does not constitute a hardship waiver. The IRS may verify whether a rollover meets the requirements for a waiver in the course of an audit. If the IRS determines that the rollover does not qualify for a waiver, a taxpayer may be subject to additional income tax and penalties.[13] Because self-certification is not a waiver of the 60-day rollover requirement, Rev. Proc. 2016-47 provides that the IRS may grant a waiver during an audit of a taxpayer's return pursuant to its authority under the Code.

DISCUSSION

Impact on Taxpayers

The elimination of the reduced filing fee for ruling requests seeking hardship exceptions to the 60-day rollover requirement appeared to be an attempt by the IRS to reduce the abundance of these PLR requests by making such applications cost prohibitive, forcing taxpayers to exercise more prudence when executing rollovers. With the publication of Rev. Proc. 2016-17, however, the IRS showed its intent was not to create barriers to hardship waivers, but rather to create an easier, cost-free self-certification procedure for taxpayers who unintentionally miss the 60-day deadline to complete a late rollover and retain the tax-deferred status of their funds.

The reasons for missing the 60-day rollover deadline that qualify for self-certification under Rev. Proc. 2016-47 comprise many, but not all, of the facts and circumstances considered by the IRS for hardship waiver enumerated in Rev. Proc. 2003-16. The list in Rev. Proc. 2016-47 includes factors that have commonly led to the grant of a hardship exception in prior PLRs, such as a death in the taxpayer's family and the illness of the taxpayer or a member of the taxpayer's family.[14] Perhaps the most lenient reason provided, and the most common justification for granting a hardship waiver, is that the deadline was missed because of errors by a financial institution associated with the rollover.[15] Taxpayers and practitioners should note that the list does not contain other common circumstances for waiver, such as the death of the taxpayer,[16] the mental condition or incapacity of the taxpayer,[17] or the erroneous advice of a financial advisor not associated with a financial institution.[18] If these reasons caused the 60-day deadline to be missed, the taxpayer must undertake the normal private letter ruling process pursuant to Rev. Proc. 2003-16 and pay the general $10,000 fee.

Impact on Financial Institutions

Financial institutions administering qualified plans or IRAs will likely view the self-certification procedure as a means to get more money in the door. But, as the acceptance of self-certified late rollover contributions is voluntary, financial institutions should consider a number of potential concerns and open questions. A financial institution should be conservative in promoting the use of self-certification. The IRS has blessed a financial institution distributing the model certification directly to clients,[19] but providing such direction could potentially be viewed as tax or legal advice by a client. If a late rollover contribution is deemed by the IRS upon audit to not meet the requirements of Rev. Proc. 2016-47, a client could seek recompense from the financial institution.

Another consideration is the administrative burden associated with the acceptance of late rollovers through self-certification. A financial institution has the responsibility of reporting self-certified late rollover contributions to an IRA on IRS Form 5498. A company must establish a procedure to track self-certified late rollovers in order to comply with this obligation and determine if it wants to bear the cost of updating system capabilities for a most likely rare tax reporting requirement. If the tracking process remains manual, the company must take on the inherent risk of human error. A financial institution must also decide how to report late rollover contributions accepted through self-certification between the effective date of Rev. Proc. 2016-47, Aug. 24, 2016, and Jan. 1, 2017. The IRS updated its 2017 Form 5498 with a new code for late rollovers applied through self-certification, but has neither updated its 2016 Form 5498 with this code, nor provided guidance on how late rollovers accepted before 2017 should be reported.

Perhaps the most important consideration is compliance with the prohibition of accepting a self-certified late rollover contribution when the financial institution has actual knowledge that is contrary to the certification. This rule is the only protection besides IRS audit against a taxpayer's abuse of the self-certification procedure. Rev. Proc. 2016-47 is silent, however, on if a financial institution with multiple businesses must investigate across all business units, or if "actual knowledge" would only apply to the business accepting the self-certification. If the IRS deems that a waiver is not appropriate upon audit, it is also not clear what penalties, if any, may be imposed on a financial institution if the IRS determines that the company had actual knowledge that the self-certification was not valid.

The requirement that a financial institution reject late rollover contributions when it has knowledge contrary to the facts of the certification will also create conflict where the financial institution and the client do not see eye-to-eye on the existence of financial institution error. One example is where a client certifies that a rollover contribution is late because of an error on the part of the receiving institution, but the receiving institution does not agree that it committed an error. In such situations, the financial institution should reject reporting the contribution as a self-certified late rollover. A client has the option of taking a different position on the client's tax return. Upon examination, the IRS could agree with the client, and exercise its authority to grant a hardship waiver in the course of an audit.

One final uncertainty is how far back in time a financial institution may look to accept late rollover contributions. Rev. Proc. 2016-47 has an effective date of Aug. 24, 2016, but does not provide a cut-off date for the original distribution that is being applied as a late rollover. A conservative approach would be to not accept rollovers of distributions occurring before Jan. 1, 2016, to prevent potential abuse.

CONCLUSION

The self-certification procedure is a positive solution for taxpayers that inadvertently miss the 60-day rollover deadline. It provides a free and simple method for taxpayers to contribute late rollovers to qualified plans and IRAs and avoids the prolonged waiting period for a PLR. The self-certification procedure should also decrease the amount of resources the IRS must spend on reviewing 60-day rollover requirement waiver requests. However, Rev. Proc. 2016-47 places much faith in the veracity of taxpayers, and relies solely on audit and financial institutions receiving late rollover contributions to prevent potential abuse. Financial institutions should carefully consider the open questions and concerns discussed above when adopting policies to accept late rollover contributions through the self-certification procedure. ■

This article represents the opinion of the author only and does not represent any opinion of his employer or affiliates.

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ENDNOTES

1 IRS News Release IR-2016-113 (Aug. 24, 2016).

2 IRC §§ 402(c)(3)(A), 403(a)(4)(B), 403(b)(8)(B), 408(d)(3)(A), 408A(e)(1)(B) and 457(e)(16)(B). Unless otherwise noted, references to the Code or "section" are to the Internal Revenue Code of 1986, as amended.

3 *Id.* § 408(i); Treas. Reg. § 1.408-5; I*nstructions for Forms 1099-R and 5498 (Jan. 8, 2016).*

4 IRC §§ 402(c)(3)(B), 408(d)(3)(I).

5 Rev. Proc. 2003-16, 2003-1 C.B. 359 § 3.01.

6 *Id.* § 3.02.

7 An eligible retirement plan as defined in the Code is an IRA, a § 401(a) qualified plan, a § 403(a) annuity plan, a § 403(b) tax-sheltered annuity, or a § 457 eligible governmental plan. IRC § 402(c)(8)(B).

8 Rev. Proc. 2003-16, 2003-1 C.B. 359 § 3.03.

9 Rev. Proc. 2003-8, 2003-1 C.B. 236 § 6.01(3).

10 Rev. Proc. 2016-8, 2016-1 I.R.B. 246 § 6.01.

11 IRS Form 5498 (2017); Instructions for Forms 1099-R and 5498 (2017).

12 *Retirement Plans FAQs relating to Waivers of the 60-Day Rollover Requirement*, Question 8, IRS.GOV, https://www.irs.gov/retirement-plans/retirement-plans-faqs-relating-to-waivers-of-the-60-day-rollover-requirement#8 (last updated Oct. 11, 2016).

13 Note that a taxpayer may still apply for a PLR if a hardship waiver is denied upon audit. *Id.* Question 9.

14 *See, e.g.*, PLR 201606032 (Nov. 9, 2015) (granting waiver due to emotional distress following spouse's death); PLR 200608025 (Feb. 24, 2006) (granting waiver due to care for disabled spouse).

15 *See, e.g.,* PLR 201618015 (Feb. 3, 2016) (granting wavier due to miscommunication by financial institution); PLR 201622039 (Mar. 3, 2016) (granting waiver due to financial institution's inability to follow taxpayer's instruction).

16 *See, e.g.,* PLR 201634026 (Aug. 19, 2016) (granting waiver where taxpayer took IRA distribution and died before completing rollover).

17 *See, e.g.*, PLR 200401025 (Nov. 5, 2003) (granting waiver where IRA withdrawal was beyond reasonable control of taxpayer suffering from Alzheimer's disease).

18 *See, e.g.*, PLR 201611024 (Mar. 11, 2016) (granting waiver where financial advisor mistakenly advised that distribution came from non-qualified annuity and would not be taxable).

19 *Accepting Late Rollover Contributions*, IRS.GOV, https://www.irs.gov/retirement-plans/accepting-late-rollover-contributions (last updated Aug. 26, 2016).

Best Practices for Actuaries Collaborating with Accountants and Lawyers

By Sheryl Flum, Rena Kuliyeva and Jacqueline Yang

Tax and statutory accounting changes present complex legal questions and challenges in product development and financial reporting, underscoring the importance of collaboration between actuarial, financial and legal departments.

To get perspective on best practices for tax actuaries collaborating with accountants and lawyers, we interviewed three representative tax leaders who included the chief tax officer (CTO), chief tax actuary, and chief tax counsel from three major U.S. insurance companies. Their comments have been paraphrased to maintain confidentiality.

WHAT IS YOUR CURRENT POSITION AND ROLE, AND HOW DOES IT FIT WITHIN THE CORPORATE STRUCTURE?

Companies have different approaches with regard to corporate structure to address oversight for tax issues due to different organizational structures and company size. Some companies have a dedicated tax actuary position to provide oversight on tax issues. At other companies, responsibility for oversight falls to the tax group or business units, with actuaries brought in as needed for their expertise. Additionally, some companies have separate tax accounting and tax counsel departments. Notwithstanding these different structures, life insurance companies often face similar challenges in responding to various tax requirements.

Chief Tax Officer:

I am a senior vice president and CTO at a large life and property and casualty (P&C) insurance company. The tax department is responsible for all aspects of tax reporting, planning, and operations, from premium and payroll taxes, to federal, state, and local income tax. The tax department reports to the chief financial officer (CFO), and provides oversight for tax issues impacting the company. My company does not have a dedicated tax actuary role, but the tax group works closely with the life actuaries on tax issues.

Chief Tax Actuary:

I'm the chief tax actuary at a large life insurance company. This position is part of the tax team, outside the regular actuarial group. In my role I act as a liaison between the tax department and the business unit actuaries, providing support for financial reporting, and working with the finance and legal teams on product development and reserve issues.

Chief Tax Counsel:

I'm the chief tax counsel at a large life insurance company. The legal and accounting teams are separate functions at my company. This has been an effective structure as it provides better governance. The legal team supports the tax accounting group on tax legal issues, including IRS and other tax audits as well as federal, state, and local taxation issues associated with the operation of the business. There used to be a dedicated tax actuary in the tax accounting group until a few years ago, but currently, we utilize an actuary who reports through the chief risk officer and spends about 50 percent of the time on tax issues.

HOW DO YOU OR YOUR TEAM INTERACT WITH ACCOUNTANTS/ LAWYERS/ ACTUARIES IN YOUR CURRENT ROLE?

Recent and upcoming statutory and tax accounting changes have increased the need for greater interaction between the finance, actuarial, and legal teams. Tax implications of principle-based reserves (PBR) for both life insurance and variable annuity products and the recently effective 2017 Commissioner's Standard Ordinary (CSO) mortality tables impact product development, product pricing, tax planning, and corporate reporting. Actuaries, accountants, and lawyers must collaborate closely to ensure assumptions, models, and reporting are aligned with the company's strategy and legal interpretation of the tax code.

Chief Tax Officer:

The tax team works closely with actuaries. Life and P&C insurance is equally weighted at our company, but over the last few years, the focus has been on life insurance. We work closely with actuaries on corporate reporting issues, including variable annuity (VA) hedging, gains/losses, and tax reserves.

The planning group in the tax department collaborates with the actuaries on modeling issues to understand the long-term ramifications of their assumptions on financial projections.

Our product development group includes the legal area and the actuaries, and the teams work closely on PBR, determining the likelihood of scenarios and which scenarios should be used.

Other initiatives over the years have included captives, reinsurance, modeling, and corporate restructuring.

Actuaries and lawyers are included in negotiations about the future status of variable annuity valuation (Actuarial Guideline 43), and are involved with industry groups to explore the impact of hedging and interest rates on AG43 and risk-based capital (RBC) implementation issues. The tax team keeps the actuaries privy to other issues, like possible future legislation on the impact of dividends, product pricing and separate accounts, keeping them educated so they know when to reach out and ask the right questions.

Chief Tax Actuary:

As a tax actuary, I work with the tax team on financial reporting and serve as consultant on product development issues. We work with valuation actuaries during the financial reporting period or to help resolve tax issues. We collaborate with financial reporting and tax attorneys on product development and have weekly calls to discuss tax developments and subjects.

We also give advice to the business units. Fluid relationships are important to develop with the business units so they can call if there are questions. We have a quarterly meeting with the business units to discuss GAAP, statutory, and tax reporting and identify issues. Attorneys are not regularly included in these calls but we bring them in when needed for additional support.

> Companies have different approaches with regard to corporate structure to address oversight for tax issues due to different organizational structures and company size.

Chief Tax Counsel:

The legal team supports the tax accounting group regarding all company tax issues associated with business operations and audits by various tax authorities, including the IRS.

We have several standing cross-functional committees that each meet regularly to discuss developments in their particular areas of responsibility. There is tax representation (accounting and/or legal) on many of these committees. These cross-functional committees deal with matters such as new product development and pricing as well as new investment opportunities. On an ad hoc basis, we will also work cross-functionally on various legislative and regulatory matters. Where insurance-specific issues are involved or insurance risks need to be quantified, actuaries are essential members of the team.

WHERE DO YOU SEE IMPORTANCE FOR MORE COLLABORATION?

As life insurance companies react to PBR and 2017 CSO, increased product innovation is expected. PBR, as well as growth of technology, has also led to companies expanding their technological capabilities, implementing valuation and administration system conversions, and data warehousing updates. Some companies are exploring the use of digital labor. Our interviewees identified technology and product development as key areas where more tax expertise was needed. Companies should consider what resources are required to ensure tax issues are addressed effectively through these initiatives.

Chief Tax Officer:
More collaboration between the actuarial and finance departments/teams on reserve issues is important as products change.

There is also a need for more collaboration on technology issues. Generally, tax is the last consideration with the technology people, and vendors do not have tax expertise. Technology initiatives like Tableau data warehouse implementation should consult with the tax department to ensure a successful outcome.

Chief Tax Actuary:
As product development becomes more innovative, there are more opportunities for actuaries and attorneys to work together. Variable annuity reserves and PBR present complex legal issues and require collaboration between these functions.

Chief Tax Counsel:
As fundamentally new actuarial standards (*e.g.*, PBR) become effective, it is particularly important for cross-functional teams (including actuaries and lawyers) to work together to plan for the impact, if any, on in-force business as well new product development and pricing. The design and redesign of various actuarial systems is another area where collaborative, cross-functional teams are particularly important throughout the design and redesign process. Tax can't be an afterthought—that is highly inefficient.

As fundamentally new actuarial standards (e.g., PBR) become effective, it is particularly important for cross-functional teams … to work together … on in-force business as well new product development and pricing.

IN YOUR VIEW, WHAT ARE SOME BEST PRACTICES FOR THESE TEAMS TO COLLABORATE SUCCESSFULLY?

Our interviewees all agreed that good relationships and frequent communication between actuarial, financial reporting, and legal teams are key to ensuring tax issues get addressed appropriately and efficiently. Regular meetings that include all the key players can help foster relationships and ensure buy-in from different functions on major company initiatives. Responsibility of oversight on tax issues should be established as part of the corporate governance process to provide accountability. Educating actuaries on tax requirements is essential to making sure they know how to identify issues.

Chief Tax Officer:
Good relationships and communication are key. People need to understand what impacts them and who they should talk to. Actuaries are not necessarily tax experts, and good communication between the tax and actuarial teams is key to making sure tax issues are being addressed appropriately.

Regular meetings that are defined and visible will help foster relationships and make sure both teams know what's important to each. We have quarterly meetings with the chief financial officer and with business units to ensure everyone has a uniform view on issues.

For repetitive work like financial reporting, all the relevant parties should be involved, and processes should be mapped out, including accountability and timing. This allows people to know right up front where there are significant handoffs. Automating the process helps people to be more self-sufficient and decreases risk.

For critical projects, in order to have buy-in, all the relevant parties need to be involved and committed to the decision-making process. Meetings should be project-oriented and have a set objective and agenda. All elements of the project should be considered, including timing and monitoring. The tax team needs to communicate what it needs and when. Information should be coordinated with controllership and timing well defined at a more granular level for staff.

Regular educational meetings with relevant parties are also important. Actuaries are not necessarily tax experts, and having regular educational meetings to provide updates on tax issues helps ensure they stay informed and know when to reach out and ask the right questions. Having a dedicated tax actuary would be helpful, but you have to go product by product.

Chief Tax Actuary:
Good relationships between various functions are key. It's helpful to have multi-functional teams that meet regularly. This helps to build relationships and foster better working interactions. Having a large network within the company means people know the right person to go to with issues.

It's not always helpful to have everyone included at the same time, but it's important to have the right levels of communication when needed. There needs to be a feedback loop so that different functions know what others are doing, what actuaries are reporting, and how it gets captured in the overall reporting.

Corporate structure can play an important role, establishing responsibility of oversight. A product tax compliance group, divided into areas of responsibility with business units, has been an effective structure to ensure someone is considering tax issues full time. Attorneys and tax actuaries need to be plugged in. Having a dedicated tax actuary is helpful—you can't expect every actuary to be an expert on tax, and it's good to have someone who understands oversight over tax issues.

Chief Tax Counsel:

You can't overemphasize the importance of regular and systemic communication. Make sure everyone whose expertise is relevant is included in the communication loop. One of the keys to being effective is understanding each other's worlds and knowing when there is an issue, and who to call. Not everyone will have deep expertise in all areas, but everyone needs to know enough to know what we don't know. Good working relationships with lawyers and accountants are key. Committees that include all of the relevant functional areas are an effective model. Frequency of interaction will play a role in ensuring people ask questions and understand the nuanced application of the law.

It's crucial for management and senior leaderships to actively encourage this culture.

Providing training for actuaries on tax issues is also important. There is concern that the actuarial licensing requirements do not place enough emphasis on tax, and as a result, some actuaries do not have enough sensitivity regarding statutory and tax frameworks (and their respective differences). Actuaries don't need to be experts, but need to be aware of how to identify concerns and ask questions as they arise.

CAN YOU PROVIDE SOME REAL- OR IDEAL-WORLD EXAMPLES OF EFFECTIVE STRATEGIES?

Our interviewees agreed that effective communication was key and was everyone's responsibility. Being outgoing, vocal, and proactive about building partnerships across functions ensures a successful outcome.

Chief Tax Officer:

Take ownership for developing partnerships with other functions. Include relevant parties in initiatives from the start to get buy-in. We recently had an initiative to improve our variable annuity hedging program in response to the Directive[1] that resulted from a recent IRS Industry Issue Resolution. We worked closely with the actuaries, describing what we were trying to do and explaining the IRS's decision. We involved the actuaries in industry calls and we consulted them on the variable annuity hedging model to understand how our hedges worked, how they differed from other companies, and how to improve the program. As a result, a strong partnership between the functions came about.

Chief Tax Actuary:

Tax issues are often overlooked. It's important to be vocal and make sure people know who you are. Being visible, speaking at actuarial events, and participating in in person meetings help other areas remember tax should be considered.

Chief Tax Counsel:

Being outgoing, engaged, and proactive is key. Within the business units, product managers own issues, and are expected to bring relevant expertise to what they are doing. It is most important for these folks to have the knowledge and experience to know how to ask the right questions and bring the relevant resources to bear on a particular initiative and then to make it happen.

As busy insurance tax professionals, it is easy to lose sight of the important functions that must come together for successful results. We were reminded about, and even learned, some important things about the various expertise that is needed to develop life insurance products, determine tax liabilities, and ensure appropriate and timely reporting. We thank our interviewees for their time and thoughtful comments. ■

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

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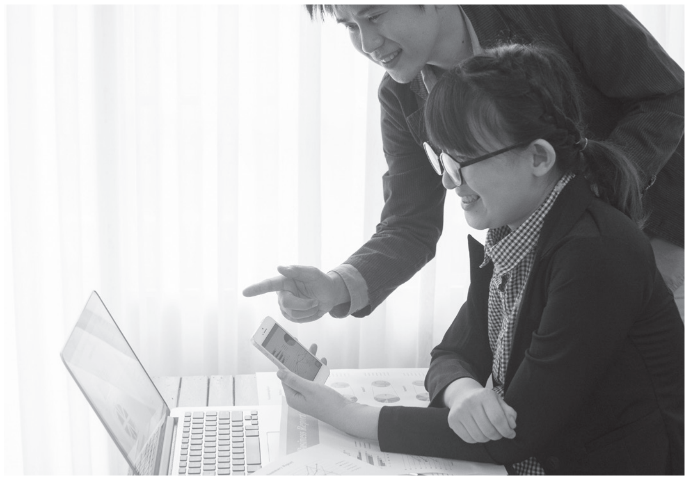
ENDNOTES

1 "I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies (LB&I-0 4-0514-0050)"

ACLI Update
AG 43 Changes on the Horizon: What Will it Mean for Tax?

By Pete Bautz, Mandana Parsazad and Regina Rose



NAIC's enactment of C3 Phase II and AG 43 in 2006 and 2009, respectively, complicated variable annuity (VA) statutory balance sheets and risk management practices and caused insurance companies to increase their use of captive reinsurance transactions.

Since 2015, the NAIC has sought to identify changes to the statutory framework for VAs that could reduce the use of captive reinsurance while encouraging strong risk management, removing volatility caused by reserve and RBC requirements, and addressing solvency requirements to better align with the economics of the business.

The NAIC commissioned Oliver Wyman to assist with this effort. A September 2015 Oliver Wyman preliminary report to the NAIC recommended several sets of ideas for improvements to the current AG 43 and C3 Phase II frameworks with a focus on:

- Reducing the asset-liability accounting mismatch between hedge instruments and statutory liabilities;
- Eliminating non-economic volatility in statutory capital charges and resultant solvency ratios; and
- Fostering greater harmonization across insurers and products for greater comparability.

The NAIC undertook a Quantitative Impact Study (QIS) with selected VA writers, covering February–July 2016, in an effort to test the Oliver Wyman recommended ideas. While Oliver Wyman did not disclose the actual results of the QIS, the QIS provided valuable perspective to Oliver Wyman in support of the changes proposed in its September 2015 preliminary report and provided the basis for more detailed recommendations to help effectuate the desired changes.

As a result of the QIS, on Aug. 23, 2016, Oliver Wyman recommended more comprehensive changes to AG43 and C3 Phase II in three major areas: Standard Scenario, Stochastic Reserves and Hedging.

Oliver Wyman's recommendations for changes to the Standard Scenario are intended to more closely align the Standard Scenario with the stochastic CTE framework. The recommended changes suggest the Standard Scenario does not capture the risk arising from modern variable annuity guarantees and is therefore not aligned with the stochastic modeling. The proposed modifications to the Standard Scenario change the purpose for which the Standard Scenario was originally intended.

In 2010, the IRS issued interim guidance in Notice 2010-29 which acknowledged the AG-43 Standard Scenario as then defined to be acceptable as the federal tax reserve. The Oliver Wyman recommendations noted above, if adopted by the NAIC, would change the Standard Scenario significantly and raise questions about the tax impact of those changes.

ACLI and its member companies, together with several of our members' outside advisors, have embarked upon a process to review current AG 43 tax guidance with the IRS. That process will address whether reserves determined under the valuation manual in their entirety qualify as CRVM or CARVM under Section 807 of the Internal Revenue Code, and should therefore, be deductible subject to any appropriate adjustments for tax. Depending upon the outcome of that review, changes currently being considered to AG 43 could require future review at the NAIC in order to allow companies to have an appropriate basis for calculation of a proper tax reserve.

The industry has recommended and the NAIC has determined that a second QIS should be conducted to provide a more thorough view of the multitude of changes recommended by the

Oliver Wyman August report. The Oliver Wyman proposals acknowledge that regulatory considerations are the foremost objective of their recommendations. However, since these recommendations are comprehensive and complex, ACLI will work closely with the IRS and the NAIC in order to properly design a VA reserve construct that will satisfy the holistic needs of companies.

PBR PRODUCT TAX GUIDANCE: NOTICE 2016-63 PROVIDES SAFE HARBOR GUIDANCE ON USE OF 2017 CSO MORTALITY TABLES

On October 20th, the IRS released Notice 2016-63 with safe harbor guidance on use of the 2017 CSO Mortality Tables under §7702 of the IRC. It provides that a mortality charge with respect to a life insurance contract will satisfy the requirements of §7702(c)(3)(B)(i) as long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after Dec. 31, 2019, or (b) the contract is issued before Jan. 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.

ACLI and member companies are pleased with the guidance. The guidance provides life insurance companies with more flexibility to administer and manage policy compliance for federal tax purposes. The guidance improves on Notice 2006-95, which addressed CSO tables transition issues for the 2001 CSO tables, and extends the improved treatment for transition to 2017 CSO tables. It provides that "if the only change to an existing contract is a reduction or deletion of benefits provided under the contract, such a change will not affect the determination of the issue date of a contract for purposes of the reasonable mortality charge safe harbor." It also provides flexibility regarding reinstatement of contracts by not requiring the contract's cash value be computed under a new mortality table if a contract is reinstated as required under applicable state or foreign law. ■

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T³: *Taxing Times* Tidbits Subchapter L: Can You Believe It?

Prevailing Standard Mortality and Morbidity Tables May Be Adjustable for Tax Reserves

By Peter H. Winslow

Life insurance companies sometimes find that standard mortality and morbidity tables do not provide adequately for their statutory reserve liabilities for a variety of products. As a result, adjustments to statutory reserves are being made to standard mortality and morbidity tables frequently based, at least to some degree, on company or industry experience. Recently, this has been the case particularly for disability income and group annuity contracts. The tax question inevitably arises: can the company-specific adjusted statutory assumption for mortality or morbidity be used for tax reserves? The answer is—it depends on whether the prevailing standard table can be "adjusted as appropriate" under I.R.C. § 807(d)(2)(C).

Let's review the basic rules. I.R.C. § 807(d)(1) generally provides that the life insurance reserve for any contract is the greater of the net surrender value of the contract or the federally-prescribed reserve (FPR). The FPR is determined by using (i) the tax reserve method applicable to the contract, (ii) the greater of the applicable federal interest rate or the prevailing state assumed interest rate, and (iii) the prevailing commissioners' standard tables for mortality and morbidity. The tax reserve is then capped by the statutory reserves with respect to the contract set forth in the annual statement.

I.R.C. § 807(d)(5)(A) provides that the prevailing commissioners' standard tables means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners (NAIC) that are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states. There is an important exception to this general rule. In addition to providing that the tax reserve is based upon the prevailing standard mortality table, I.R.C. § 807(d)(2)(C) provides that the prevailing table can be "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account."

The prevailing mortality table required to be used for tax reserves is a table that reflects "standard" mortality for the benefits to which the table relates. An adjustment to the table is appropriate under I.R.C. § 807(d)(2)(C), and may even be required, when an evaluation of insureds indicates that the mortality risks are not standard in relationship to the table. This can occur in life insurance when a contract is sold without underwriting (guaranteed issue) or when the insured lives are unhealthy or likely to be. In these circumstances, an extra premium generally is charged for the nonstandard risk and a reserve adjustment is made. The same is true for annuities if the annuitants are too healthy compared to standard lives. When an objective characteristic of the annuitants, or underwriting of the risks, reflects a likely deviation from the standard mortality under the applicable table which results in increased longevity risk, an extra premium is charged and extra reserves are established. Thus, for both life insurance and annuities, an adjustment to the standard table may be needed when risks are not reflected in the prevailing table for standard mortality. This is most likely to occur when the objective nature of the insured lives or underwriting indicates that the risks are nonstandard and, typically, an extra premium is charged for the coverage.

The legislative history elaborates on when an adjustment to the prevailing table may be appropriate:

> The Federally prescribed reserve requires the use of the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks, such as substandard risks, incurred under the contract which are not otherwise taken into account. If, for example, the commissioners' standard tables differentiate between smokers and nonsmokers, reserves relating to insureds that are otherwise standard risks except for known smoking habits must be computed using the commissioners' standard table for smokers without any adjustment to reflect substandardness due to smoking. This is appropriate because the factor of smoking is already taken into account, and any excess mortality due to such factor is implicit in the use of the smokers' table. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because

of poor health or medical condition. An appropriate multiple should reflect the greater mortality expected, for example, from a person with a known heart or diabetic condition, in excess of the mortality of the group of standard insureds that is implicit in the prevailing commissioners' standard table. Also, adjustments to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks); or because the insureds reside in a foreign country known to be experiencing civil strife.[1]

This legislative history suggests that it is not sufficient to merely show that a company's particular group of insureds may have mortality or morbidity rates that *differ* from the prevailing table. Rather, in order to adjust the prevailing standard mortality or morbidity table, the company must demonstrate that its risks *were not reflected or implicit* in the prevailing table. Guidance from the IRS confirms that this is its interpretation of I.R.C. § 807(d)(2)(C).

In TAM 9251005,[2] an actuary determined that the company's disability income policies contained a definition of disability and provided benefits that were not reflected in the morbidity factors of the prevailing standard morbidity table. As a result, the company made adjustments to the prevailing table to reflect the risks not covered. The IRS agreed that this adjustment was permissible for tax reserves. In fact, the IRS went further and suggested that an adjustment to the prevailing table may be appropriate for tax reserves in these circumstances even though a similar adjustment had not been made for statutory reserves.

By contrast, in TAM 200416009,[3] actuaries determined that their company's mortality experience under annuity contracts was less than that reflected in the prevailing table. As a consequence, the company adjusted the mortality table for its own experience by decreasing the mortality assumptions. In ruling against the taxpayer, the IRS set forth what it considered to be the initial hurdle to overcome to qualify for an adjustment to the prevailing table:

> As reflected in the examples provided [in the legislative history], in order to justify a modification of the tables, the Taxpayer must be able to show not merely that its experience differs, even significantly differs, from the experience assumed in the tables. Rather, the Taxpayer must also show that its population reflected a risk 'not taken into account' . . . In adopting the language 'adjusted as appropriate to reflect the risks . . . not otherwise taken into account', Congress meant to allow reserves for

> additional risks such as smoking that are in excess of the core contingencies. The Taxpayer did not perform any study or analysis that would identify a characteristic of its annuitant population associated with greater risk or a characteristic not identified with the characteristics of the mortality table pool in general. The only analysis performed by the Taxpayer was an analysis of mortality . . . Accordingly, Taxpayer may not adjust the applicable mortality table in connection with its immediate and supplementary annuity contracts for risks incurred that were taken into account in computing the applicable prevailing commissioners' standard mortality table and, therefore, were not risks 'incurred under the contract which are not otherwise taken into account.'

TAM 9251005 and TAM 200416009, taken together, suggest that the IRS views the "adjusted as appropriate" analysis as a two-step process. The first step is to determine whether an adjustment to the standard table is required for nonstandard risks. For this step, it is necessary to examine the underlying data used in developing the prevailing table and then determine if the company's particular risks were reflected in that underlying population. Only after this step is satisfied can the company proceed to the second step and determine the "appropriate" level of the adjustment for the nonstandard risks.

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In the first step, a comparison of the standard risks considered in the prevailing table with the risks covered in the company's contracts is required. There are two types of risks for which adjustments to the prevailing table are appropriate as reflected in these two TAMs. One type of risk is reflected in TAM 9251005, where an adjustment to the table was necessary because the disability contract provided a benefit that was not reflected in the underlying table, and because the additional benefit was likely to result in a different morbidity risk. In other words, the prevailing table did not reflect the same benefits, and, therefore, different morbidity experience could be anticipated. This is the type of situation that frequently gives rise to a table adjustment for disability income policies.

A second type of risk for which an adjustment is required arises for substandard or nonstandard risks. This is a situation where the contract benefits are the same as assumed in the table, but the demographics of the insured lives reflects a different level of risk. This is the more likely situation for individual life insurance contracts insuring substandard risks. More recently, this situation is arising for group annuity contracts where the facts are distinguishable from the annuity contracts in TAM 200416009. In that TAM, the company issued annuity contracts to standard risks and sought to adjust the table because its own experience indicated greater longevity than the standard table. The adjustment was denied for tax purposes because the table reflected the same standard risks as in the company's contracts. To make an adjustment as appropriate, it must be established that the contract covers nonstandard longevity risks that annuitants could live longer than those reflected in the standard table.

Once it is determined that an adjustment to the standard table is necessary, the next step is to determine the amount of the adjustment that is appropriate. This can be determined by using the company's own experience to the extent it is credible, industry-wide experience or a combination of both. It is important to understand that company and industry-wide experience, standing alone, cannot be used to support an adjustment to the prevailing table for standard risks. But, experience can, and probably should, be used to determine the "appropriate" adjustment. What is ultimately determined to be an appropriate adjustment requires actuarial judgment that is not likely to be challenged successfully by the IRS if it is supported by contemporaneous actuarial analysis, and especially if (despite the implied leniency in TAM 9251005) the adjusted mortality or morbidity assumptions also are used for statutory reserves. ■

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ENDNOTES

1 Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 603 (1984) (footnote omitted). See also H.R. Rep. No. 98-432, pt. 2, at 1416 (1984); S. Prt. No. 98-169, vol. I, at 542 (1984).

2 (Sept 9, 1992)

3 (Apr. 16, 2004)

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