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SOA STAFF

Beth Bernardi, Staff Partner
bbernardi@soa.org

Ladelia Berger, Section Specialist
lberger@soa.org

Julia Anderson Bauer, Publications Manager
jandersonbauer@soa.org

Kathryn Baker, Staff Editor
kbaker@soa.org

Erin Pierce, Graphic Designer
epierce@soa.org

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475 N. Martingale Road, Suite 600
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Phone: 847.706.3500
Fax: 847.706.3599

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From the Chair “Interesting Times”

By Don Walker

I love Wikipedia. No matter how esoteric the subject, I can usually find out something about it by trolling around the free online encyclopedia. As I sat at my computer today (I still use a desktop) contemplating what to say in late March for an article in a newsletter to be published in June that would inform an audience of tax actuaries, all I think of initially was that so-called “Chinese Curse” about living in “interesting times.” So I did the only logical thing—I wiki’d it.

Turns out that the curse may not be Chinese at all. While the usual formulation is attributed to Bobby Kennedy in 1966, the wiki article redirects to British parliamentary speech from 1898 and appears in 1936 correspondence of Austin Chamberlain (brother of Neville, British PM leading up to WW2). It was also used by Hillary Clinton in her 2003 memoir *Living History* and was used in *Star Trek Voyager*, season 1, episode 6. All of which isn’t helping me with my problem—what to say about how we in the Taxation Section propose to help YOU, our reader of the June issue of *TAXING TIMES*, deal with 2017 changes to U.S. Tax Code and associated regulations.

So putting aside an interesting digression, what ARE we going to do to help you deal with all of this (assuming it happens in a timely manner)?

The good news is we have multiple ways to keep you informed, and we plan to use all of them. The challenges will be that each of these methods have lead times. We have to anticipate and we have to react fast.

First will be sessions at major SOA meetings. We are continuing our tradition of sponsoring multiple sessions at each of the “big three” meetings—the Life and Annuity Symposium, the Valuation Actuary Symposium, and the SOA Annual Meeting & Exhibit. There will be section breakfasts, introductory sessions, and update sessions covering product tax, company tax, and principle-based reserves. You can be sure that the presenters will be prepared to comment on any major developments in Washington, as well as providing their usual fine professional education experiences.



Second will be a webinar, once we have the information that will make holding one worthwhile. It takes about six weeks for the SOA to plan and market a webinar and there is already a calendar for section-sponsored webinars, so it is difficult for me to promise an exact time frame. However, you can be assured that once we have material to share, we will move on this expeditiously.

Third could be a podcast. Dan Theodore does a great job in narrating our podcasts. They are usually based on materials we’ve already presented in other forms, but we have the option to do one based on newly-developed material if that is the best way to get important information to our members quickly.

And let’s not forget this wonderful newsletter, *TAXING TIMES*. The challenge here is lead time. But you never know, the powers that be in Washington could act on such a schedule that works into our triannual publishing cycle. And, we could opt for a special edition, if deemed appropriate by your section council.

The council is also looking at the possibility of a Company Tax Seminar in the near future. Don’t forget to check the SOA website and the new Taxation Section webpage for late-breaking developments.

Yes, we live in interesting times. ■

Don Walker is the retired chief life actuary at Farm Bureau Life Insurance Company of Michigan and can be reached at dmawalker@aol.com.

Section 807(f) – Tax Impact of Statutory Reserve Change

By Sheryl Flum, Frederick Campbell-Mohn and Elizabeth Petrie

SUMMARY

The Internal Revenue Service (IRS) recently published a field attorney advice¹ (FAA)², which concluded that a change in the method for determining a company's statutory reserve should be treated as a change in reserve method under section 807(f).³ Prior to the FAA, there had been limited guidance on whether a change in tax reserves resulting from a change in the taxpayer's statutory cap is a change in fact—so the full amount of the change would be taken into income in the year of change, or if the change should be treated under section 807(f) and spread into income over 10 years. This article examines the interplay of section 807(f) and the statutory cap in section 807(d).

It is unclear whether the IRS's position that section 807(f) applies to the statutory reserve computation is an appropriate interpretation of section 807(f).

OVERVIEW OF TAX LAW

For tax purposes, life and annuity reserves are computed under section 807. The Code and related Treasury regulations outline the appropriate reserve methods and assumptions to use for the various types of life and annuity contracts. In general, the amount of the tax basis of life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves computed based on the tax reserving principles outlined in the Code.⁴ Section 807(d)(1) provides that in no event shall the reserve determined under these principles for a given policy (the FPR)⁵ be greater than the corresponding statutory reserve, as defined in section 807(d)(6). If the FPR is greater than the statutory reserve, the tax

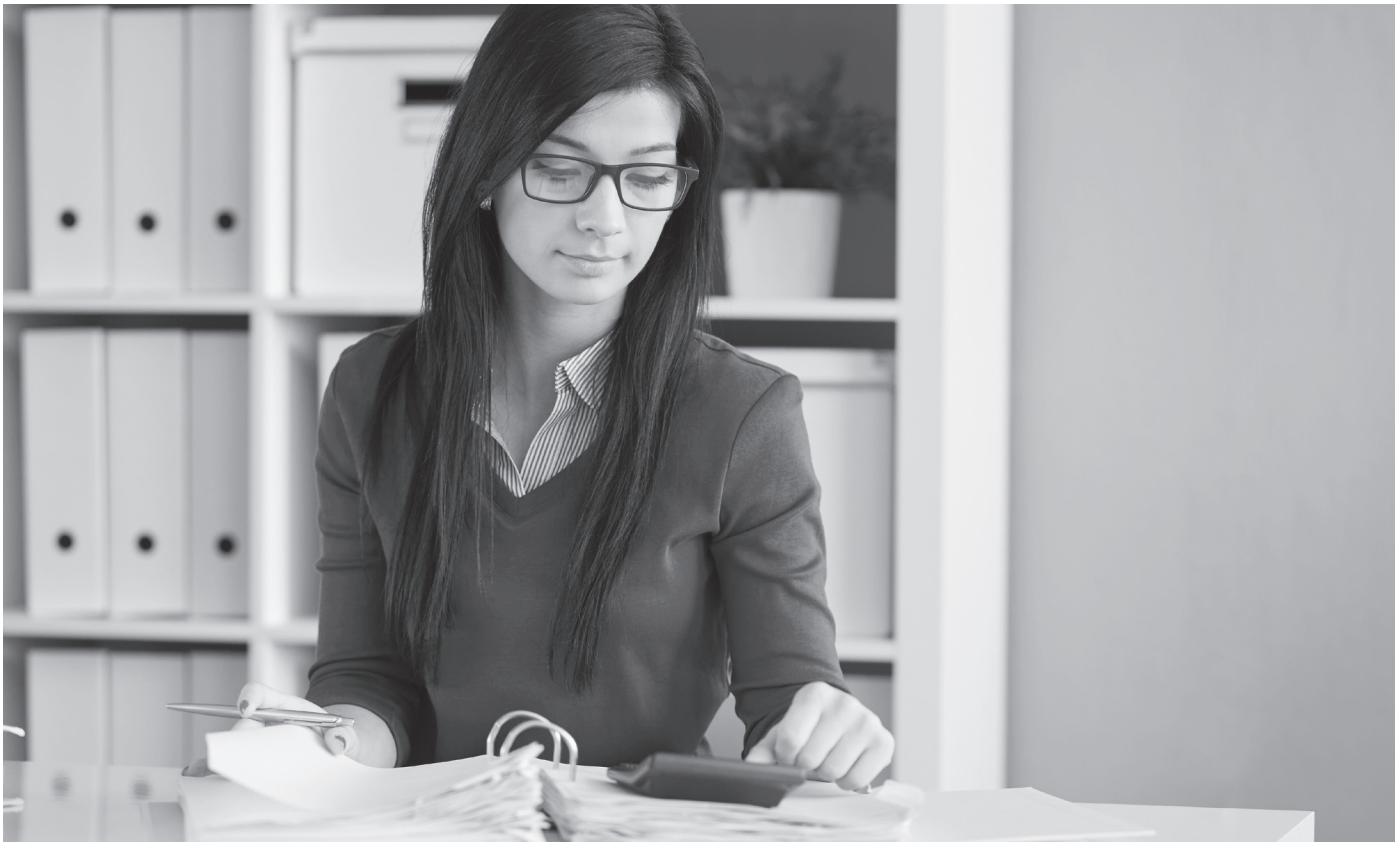
reserve is limited to the statutory reserve. This concept is referred to as “statutory capping.”

For example, in some circumstances a company might find that it is using more conservative assumptions in calculating tax reserves than in calculating statutory reserves. In this circumstance, the FPR for those contracts will exceed the statutory reserve, but the tax reserve would be limited to the statutory amount. It is possible the company might then change its method of calculating the statutory reserve for such a contract so that the tax reserve is no longer subject to the statutory cap or the amount of the statutory reserve used for tax purposes increases or decreases.

The latest piece of guidance in this area was issued in December 2016, when the IRS released the aforementioned FAA. The taxpayer was the parent of a life-nonlife consolidated group that included two life insurance companies. The life insurance company subsidiary of the parent marketed a rider to specified annuities. In performing statutory and FPR reserve valuations for the first three years, the company understated its reserve liabilities. During these years, the understated statutory reserve served as a cap on the amount of the tax reserves. The understated statutory reserves were subsequently corrected in Year 4. Also in Year 4, the taxpayer amended the Year 2 and 3 tax returns, claiming to have changed the FPR method in Year 2 when it recomputed its tax reserves to correct for the improper application of Actuarial Guideline 33 (AG 33) for Year 2 and Year 3. However, there was no change to the taxable income for Years 2 and 3 because the tax reserve was limited under section 807(d)(1) to the understated statutory reserve. The taxpayer reported an increase in statutory reserves at the beginning of Year 4 due to the change in the understated reserve at the end of Year 3. The corrected (and higher) statutory reserves no longer capped the tax reserves. As recounted in the FAA, the taxpayer argued that the increase to the tax reserves as a result of the elimination of the statutory cap was not subject to section 807(f) because there was no change in Year 4 to the computation of the FPR under section 807(d).⁶ The IRS, however, concluded that the change to the statutory reserve should be subject to section 807(f).⁷

CHANGE IN ACCOUNTING METHODS

Under general tax accounting policies, one must request permission from the IRS to change a method of accounting.⁸ This impact is then spread into income over a period of one to four years, depending on whether the change is positive or negative.⁹ Certain changes in accounting methods have been deemed by the IRS to be automatic, and in those cases the taxpayer does not need to request permission before changing the method.¹⁰ Whether the change is automatic or non-automatic, the taxpayer must still file Form 3115.



In the case of reserves defined under section 807(c), neither “changes in basis” nor “corrections of errors” are governed by section 446 and permission to change is not required. Changes in basis are spread into income over a ten-year period.¹¹ These changes are often referred to as section “807(f) adjustments.” Conversely, errors are corrected by adjusting the reserve in the year of the error.¹² For changes in basis, the section 807(f) adjustment is computed by taking the difference between (a) the amount of the reserve at the close of the taxable year, computed on the new basis and (b) the amount of the reserve at the close of the taxable year, computed on the old basis, both amounts computed with respect to contracts issued prior to the taxable year.

The statutory language indicates that a change in “the basis for determining any item referred to in [section 807(c)]” would be subject to section 807(f). Changes to the methods and assumptions underlying the FPR are fairly universally viewed as changes in basis, at least as long as the prior method or assumption was used for more than one taxable year; however, it is less clear whether a change in the statutory reserve computation that impacts the tax reserve would be subject to the 10-year spread. There are two ways to look at changes to the statutory reserve; such adjustments can be viewed as changes in fact or changes in reserve method.

CHANGE IN FACT

In its guidance,¹³ the IRS has stated that section 807(f) applies to changes in reserve bases that would be changes in accounting methods under section 446 if section 807(f) were not part of the Code. But a change in fact isn’t either a change in accounting method or a section 807(f) adjustment.¹⁴ So if a change in the method for determining the statutory reserve for purposes of the statutory cap is a change in fact, section 807(f) would not apply.

As summarized by Edward Robbins and Richard Bush,¹⁵ a change in fact occurs when there is a change in terms of an existing insurance contract such as: (1) changes in the net surrender value of a contract,¹⁶ (2) increasing benefits under a policy,¹⁷ (3) conversion of collectively renewable accident and health policies to guaranteed renewable policies¹⁸ and (4) the addition of an indemnity benefit should death occur from a non-occupational vehicular accident, at no additional premium cost.¹⁹ There have been a number of private letter rulings in which the IRS has addressed the tax consequences of policy update programs where the insurance company increased death benefits on policies at the same time as increasing the valuation interest rate on the reserves underlying the policy. The IRS concluded that these programs resulted in an

exchange of policies, and were not changes in basis that would require a 10-year spread under section 807(f).²⁰

As discussed in an article by Peter Winslow and Lori Jones,²¹ “a change in method of accounting does not occur even if large one-year reserve adjustments are made if all that is happening is that the old accounting method is being applied to a change in circumstances.... [For example, when] an insurance company adds benefits to the contract, the reserves must be increased to reflect additional benefits guaranteed in the contract. These reserve increases are not subject to section 807(f) because the basis of computing the reserve has not changed—the only change is in the underlying facts.”²²

Relying on the correlation between the net surrender value and the statutory capping in computing tax reserves, an adjustment to the method for determining the statutory reserve could be viewed as a change in fact. As noted above, tax reserves may not be less than the net surrender value of the contract or greater than the statutory reserves. One could view the net surrender value as the floor and statutory capping as the ceiling when computing tax reserves. This view supports the position that a change in the statutory cap arising in the normal course of operations, similar to a change in the net surrender value floor, does not give rise to a section 807(f) adjustment. This position is further supported by the language in the 1984 Act Blue Book which provides that changes in net surrender value are not subject to section 807(f).²³ Specifically, the 1984 Act Blue Book states that changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability. The IRS considered this argument in the FAA, but rejected it.²⁴

Similarly, the statutory cap may be characterized as a limitation on the amount of the reserve that may be deducted. Based on *Principal Mutual Life Insurance*,²⁵ a limitation on the amount of the deduction does not change the timing of the deduction. Instead, it simply limits the amount that is deductible. The IRS considered this argument in the FAA even though they did not ultimately follow this reasoning.²⁶

The taxpayer in the FAA treated the adjustment as a change in fact, claiming that the only method of accounting involved in the computation of tax reserves was the method of computing the FPR under section 807(d), which changed in Year 2 but with an ultimate effect of \$0 due to the operation of the statutory cap. The taxpayer most likely argued that a change in the statutory reserve limitation, and presumably also the net surrender value floor, was not a change in basis if the FPR did not change.²⁷



CHANGE IN BASIS

As mentioned previously, the recently published FAA concluded that a change in the method for determining a company's statutory reserve should be treated as a change in reserve method under section 807(f). This section outlines the IRS's analysis in that FAA in reaching its conclusion.

Prior Code section 810(d), as enacted by the Life Insurance Act of 1959, had language similar to current section 807(f). However, under the 1959 Act, there was no FPR concept. Instead, tax reserves were based on statutory reserves. So the “change in basis” wording in former section 810(d) could only have applied to the basis of computing the statutory reserve. Thus, the IRS argued, perhaps the carryover of the former section 810(d) language to current section 807(f) indicates that Congress intended for the change in basis concept to apply to both the FPR and the statutory reserve.

Section 807(f) is properly viewed as a subset of accounting method changes otherwise subject to section 446²⁸ and the same interpretation was adopted in Revenue Ruling 94-74.²⁹ The IRS recently reiterated this connection between section 807(f) and section 446 in a 2015 private letter ruling,³⁰ which indicated that the section 807(f) change-in-basis rule was applicable where certain life insurance contracts were treated as being reinsured when they actually were not.

In the FAA, the IRS concluded that the adjustment to the statutory reserve should be treated as a section 807(f) adjustment.

In making this determination, the IRS relied on case law in *Huffman v. Commissioner*³¹ and *American Mutual Life Ins. Co. v. United States*.³² In the former case, the court determined that a change in method of accounting is an adjustment to the consistent treatment of an item that affects the timing for recognition of the item and does not permanently change lifetime income. In the latter, the court concluded that the computation of life insurance reserves does not have a permanent effect on the taxpayer's lifetime taxable income, as any deduction for the increase in reserves will ultimately be offset by the release of the reserve and the recognition of this amount of income. The IRS further asserted that, under section 807(d), the required tax reserve is generally the FPR unless the statutory reserve is lower. Thus, the IRS stated in the FAA that both the tax reserve computation and the statutory reserve limitation are components of the method of accounting for reserves, to the extent that the respective components are consistently applied, and determine the final tax reserve in any particular year.³³ Therefore, the IRS argued, a change in the reserve method under section 807(d) is subject to section 807(f) regardless of whether it arises from a change to the FPR or a change in the application of statutory capping.

APPLICABILITY OF SECTION 807(f)

It is unclear whether the IRS's position that section 807(f) applies to the statutory reserve computation is an appropriate interpretation of section 807(f). As summarized by Edward Robbins and Richard Bush, "the legislative history for section 807 supports the conclusion that the statutory cap is not a "method" of computing reserves. The 1984 Act Blue Book provides that, generally, section 807(f) applies "only if there is a change in basis in computing the [FPR] (as distinguished from the net surrender value)." This language suggests that only changes in the computation of the FPR are subject to the 10-year spread rules."³⁴

In Notice 2010-29,³⁵ the IRS detailed the impact of Actuarial Guideline 43 (AG 43) on the calculation of tax reserves. For many taxpayers, the adoption of AG 43 resulted in lower statutory reserves for accounting purposes, which in turn decreased tax reserves due to statutory capping in section 807(d)(1). This notice provided interim guidance, including a rule that the effect of statutory capping as a result of the adoption of AG 43 must be spread over ten years. The notice was careful not to reference the change as being governed by section 807(f), and in fact explicitly stated that no inference can be drawn from the notice regarding any federal tax issues that arise under any actuarial guideline other than AG 43.

In addition, Rev. Rul. 94-74 provided an example where the IRS interpreted the scope of section 807(f) broadly. This ruling addressed the applicability of section 807(f) to four situations in which a life insurance company made changes to its

However, the FAA only constitutes field advice, which is relevant, but does not represent substantial authority on which a taxpayer can indisputably rely.

reserves. The first situation involved a change in the mortality table used to compute the reserves; the second involved a change in the interest rate used; the third involved a changed assumption from a curtate to continuous function; and the fourth involved a computer program error which caused certain policies to be omitted from the computation altogether. In each of the first three situations, the revenue ruling concluded that the change was a change in basis subject to section 807(f) and, thus, the 10-year spread rule applied. Situation four postulates a fact pattern where a reserve is properly computed, but because of a computer error, is not included in the sum of total reserves for the year in question. The ruling concluded the change is the correction of an error and not subject to the 10-year spread rule. The revenue ruling was significant in that it concluded that even changes in the computation of reserves for items which are mandated by statute, such as interest rates or mortality tables, are changes in basis rather than corrections of errors.

In the 2015 private letter ruling mentioned above,³⁶ the IRS concluded that the section 807(f) change-in-basis rule applied where certain life insurance contracts were treated as being reinsured when they actually were not, which resulted in the life insurance reserves for the contracts being recorded in the wrong legal entity. Perhaps the most important point from that PLR was that by treating the mislabeling of the life insurance reserves as *not* being a mere posting error, the IRS maintained its position that most changes to the calculations of a life insurance reserve are *not* errors.

None of the previous guidance, however, directly supports a conclusion that section 807(f) applies to the statutory reserve computation. The calculation of the statutory reserve is not governed by the Code, which merely references the statutory reserve as a ceiling for the reserve amount included in the determination of life insurance company taxable income.

CONCLUSION

There continues to be uncertainty as to whether a change to the statutory reserve could be subject to section 807(f). The recent FAA explicitly addresses the statutory capping issue and concluded that a change to the statutory reserve should be considered a change in the reserve method under section

807(d) and subject to section 807(f). However, the FAA only constitutes field advice, which is relevant, but does not represent substantial authority on which a taxpayer can indisputably rely.³⁷ To announce this position officially, the IRS should propose guidance and allow potentially affected taxpayers to comment on such proposal. And, any new rule developed should be applied on a prospective basis. ■

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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Sheryl Flum is managing director in the Financial Institutions and Products group of KPMG LLP’s Washington National Tax practice and may be reached at sflum@KPMG.com.

Frederick Campbell-Mohn is managing director in the Financial Institutions and Products group of KPMG LLP’s Washington National Tax practice and may be reached at fcampbellmohn@KPMG.com.

Elizabeth Petrie is manager in the Financial Institutions and Products group of KPMG LLP’s Washington National Tax practice and may be reached at epetrie@KPMG.com.

ENDNOTES

- 1 20165101F (Dec. 16, 2016).
- 2 An FAA is a memo prepared by field attorneys in the IRS Office of Chief Counsel that is reviewed by an Associate Office. An FAA cannot be used or cited as precedent.
- 3 Unless otherwise noted, all references to sections are to the U.S. Internal Revenue Code of 1986, as amended (the Code), and to the Treasury regulations issued thereunder.
- 4 Section 807(d)(1).
- 5 Federally Prescribed Reserve under section 807(d).
- 6 Because the FAA is prepared internally within the IRS, the taxpayer does not have the opportunity to provide input. So all that is known is the IRS’s interpretation of the taxpayer’s position.
- 7 The IRS’s position raises an interesting question: If a company amends its FPR in a year where it wasn’t originally capped, but subsequently becomes capped after amendment, would the IRS determine that section 807(f) applies to both the change to the FPR starting in the year of the change and the statutory reserve starting in the year the reserve becomes capped?
- 8 Section 446(e).
- 9 Section 481(a).
- 10 Rev. Proc. 2016-29.
- 11 Section 807(f).
- 12 Rev. Rul. 94-74, 1994-2 C.B. 157, Situation 4.
- 13 See Rev. Rul. 94-74, 1994-2 C.B. 157. See also I.R.S. Priv. Ltr. Rul. 201511013 (March 13, 2015).
- 14 See Treas. Reg. §1.446-1(e)(2)(iii)(b) (a change in method also does not include a change in treatment resulting from a change in underlying facts).
- 15 Robbins Edward, and Richard Bush. 2014. *Tax Basis Assets and Liabilities of US Life Insurers*. New Hartford: Actex. 178–179.
- 16 Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 604 (1984). (“The 1984 Act Blue Book”).
- 17 Rev. Rul. 69-444, 1969-2 C.B. 145.
- 18 I.R.S. Priv. Ltr. Rul. 8139036 (June 30, 1981).
- 19 Rev. Rul. 69-444, 1962-2 C.B. 145.
- 20 See for example I.R.S. Priv. Ltr. Rul. 8008048 (Nov. 28, 1979) and I.R.S. Priv. Ltr. Rul. 8431022 (Apr. 30, 1984).
- 21 Winslow, Peter and Lori Jones. 2010. “Change in Basis of Computing Reserves – Is it or isn’t it?” *TAXING TIMES* 6 (1): 11.
- 22 See supra note 19.
- 23 The 1984 Act Blue Book, at p. 604.
- 24 See supra note 1.
- 25 *Principal Mutual Life Insurance Co. v. United States*, 48 Fed. Cl. 52 (Cl. Ct. 2000), aff’d F.3d 1241 (Fed. Cir. 2002). (Federal Circuit held that statutory reserves are not “computed” as such but are simply taken directly from the reserves in the annual statement).
- 26 See supra note 1.
- 27 See supra note 2.
- 28 This reading of the statutory scheme was articulated in *American General Life & Accident Ins. Co. v. United States*, 71AFTR 2d 93-3319 (M.D. Tenn. 1989): “There need be no conflict between section 481 and the 10-year spread rule of section 810. Code section 481 is simply a much more general provision dealing with recapture of tax income in a broad variety of cases. It is a broad rule which generally authorizes recapture.”
- 29 “Under section 446, a change in method of accounting does not include correction of mathematical or posting errors. See, e.g., section 1.446-1(e)(2)(ii)(b). Because section 807(f) is a more specific application of the general tax rules governing a change in method of accounting, a circumstance that is not a change in method of accounting under the general rules cannot be governed by the more specific rules of section 807(f). Accordingly, consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis under section 807(f).”
- 30 I.R.S. Priv. Ltr. Rul. 201511013 (March 13, 2015).
- 31 126 T.C. 322, 343 (2006), aff’d., 518 F.3d (6th Cir. 2008).
- 32 267 F.3d 1344, 1350 (Fed. Cir. 2001).
- 33 See supra note 1, at p. 7.
- 34 Robbins Edward, and Richard Bush. 2014. *Tax Basis Assets and Liabilities of US Life Insurers*. New Hartford: Actex. 185.
- 35 I.R.S. Notice 2010-29, 2010-15 I.R.B. 547.
- 36 See supra note 30.
- 37 I.R.S. Treas. Reg. §1.6662-4(d)(3)(iii)



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

Premiums Paid, Investment in the Contract, and Tax Basis – We Know It When We See It, Right?

By John T. Adney

The federal income tax law was once described by a federal judge as a conspiracy in restraint of understanding. While people—including tax professionals—at times feel that way, there are some terms in the tax law that appear reassuringly simple. And yet some of those terms are deceptively simple. This edition of the “In the Beginning” column devotes itself to exploring, at a basic level, the tax meaning of three concepts that are fundamental to the income taxation of life insurance products: premiums paid, investment in the contract, and basis.

The concepts of “premiums paid” and its companion term, “amount paid,” must be understood in order to implement, respectively, the guideline premium test of section 7702 and the modified endowment contract (MEC) rules of section 7702A.¹ The “investment in the contract,” properly calculated, is employed to determine the amounts of life insurance and annuity contract distributions that are includible in gross income for tax purposes and reportable as such by insurers. And “basis,” sometimes called “tax basis,” is important in determining taxable gains when contracts are sold or are exchanged in a manner that is not income-tax free.

Any exploration of these terms must start with the concept of “premium.” One does not need to be an actuary to comprehend the common meaning of an insurance contract premium. We all pay them, for life, auto, home and other insurance coverages, so we may assume that we know a premium when

we see one.² The Congress of the United States apparently thinks so, too, in that it has instructed those charged with calculating guideline premiums and 7-pay premiums to calculate a “premium” using certain specified actuarial assumptions but without further definition, and it also said to determine the “premiums paid” under section 7702 by looking to “the premiums paid under the contract,” albeit subject to certain adjustments discussed hereafter.³ It could be that “premium” must join “income” and “reasonable” in the Internal Revenue Code’s lexicon of irreducible terms.

But even if we know what a premium is, what is meant by “premiums paid” as it appears in section 7702(f)(1)? And how about the companion term “amount paid” in IRC section 7702A(e)(1)? To be clear, “premiums paid” is used to measure whether the cumulative premiums paid (please excuse the redundancy) for a contract at any time do not exceed the contract’s guideline premium limitation under section 7702(c) at that time, a necessity if the contract is to qualify for the normal tax treatment of life insurance.⁴ Comparably, “amount paid” is employed to track the amount and timing of each premium paid for a life insurance contract to determine whether the contract is or has become a MEC within the meaning of section 7702A(a).

For these purposes, the Code spells out some details. Specifically, section 7702(f)(1) defines “premiums paid” as the premiums paid (again, excuse the redundancy) under a contract less four items:

- Distributions, other than amounts included in gross income, to which section 72(e) applies;
- Any excess premiums with respect to which there is a distribution described in section 7702(f)(7)(B) or (f)(7)(E);
- Any amounts returned to the policyholder—with interest—within 60 days of the end of a contract year in order to comply with the guideline premium test; and
- Any other amounts received with regard to the contract that are specified in regulations.

This impressive list of reductions in premiums paid—and reductions are good news for attaining compliance with the guideline premium test—warrants a little explanation. The first item, “distributions,” refers to amounts paid from or under a contract that are not taxable, such as policyholder dividends and partial withdrawals that are treated as recovering investment in the contract (which will be defined later) under the rules of section 72(e).⁵ The second item, “excess premiums,” is more complex to explain, but suffice it to say that they are amounts subjected to tax by virtue of section 7702’s “recapture ceiling” rules—rules that today tend not to be significant apart from section 1035 exchanges.⁶ The third item is even more

complex in operation, but in essence it encompasses premiums previously paid that are returned to the policyholder promptly after the contract year-end and with interest.⁷ In contrast, the fourth item is easy to explain: there are no regulations implementing it, so for practical purposes it doesn't exist.

As for the MEC rules, section 7702A(e)(1) contains a somewhat simpler definition of "amount paid," stating that it consists of the premiums paid⁸ under the contract, less distributions described in the first and third items above, with one modification. Hence, in determining the amount paid for section 7702A testing purposes as of any time, the cumulative premiums paid to that time generally are reduced by (1) amounts paid from or under a contract that are not taxable because they are treated as recovering investment in the contract under section 72(e) and (2) premiums previously paid that are returned to the policyholder promptly after the contract year-end and with interest. The modification is that amounts borrowed, assigned or pledged under a contract are not treated as paid from or under the contract, as they otherwise would be in the case of a MEC.⁹

While the section 7702(f)(1) definition thus shares some common ground with the section 7702A(e)(1) definition, the two diverge markedly in the case of a contract exchange, such as an exchange that is tax free under the section 1035 rules. For section 7702 purposes, the premiums paid include the value coming into the new contract from the replaced contract, *i.e.*, usually the value received by the new insurer in the exchange that is treated as premium for annual statement purposes. However, because of a special rule developed for section 7702A because of that statute's sensitivity to how rapidly premiums are paid for a contract (it typically doesn't approve of contracts that are quickly paid up), the amount paid does not include the value coming over from the replaced insurer. Rather, pursuant to the section 7702A(c)(3)(A)(ii) "rollover rule," a downward adjustment is made to the 7-pay premium—the amount allowed to be paid without creating a MEC—to account for the cash value arising out of the exchange.

Now that the concept of premiums paid (and amount paid) as used for section 7702 and 7702A purposes is perfectly clear, it remains important to examine the role that the concept plays in determining the investment in the contract and in measuring tax basis. In particular, it is vital to understand the manner in which the several definitions diverge.

The "investment in the contract," as noted above, functions to determine the taxable amounts of life insurance and annuity contract distributions. (Since the death benefit paid under a life insurance contract typically is income-tax free, the life insurance distributions of concern here are ones made while the insured is living; annuity benefits, whether paid before or



after death, usually are taxable.) The definition of the investment in the contract as relevant to distributions that are taxed as "amounts not received as an annuity," such as partial withdrawals and complete surrenders, is found in section 72(e)(6).¹⁰ In that provision, the investment in the contract as of any date is said to equal "the aggregate amount of premiums or other consideration paid for the contract before such date minus the aggregate amount received under the contract before such date, to the extent such amount was excludable from gross income...." (It appears that the phrase "other consideration" is used in the statute to accommodate annuity contributions, exchange proceeds to a limited degree (see below), or similar items that some may not colloquially think of as premiums.) Thus, in general, the investment in the contract is calculated as the premiums paid, less prior contract distributions that were not taxed. It should be noted that the investment in the contract is sometimes called "cost basis," and while there is nothing inherently harmful in so referring to it, it should



not be confused with “basis” in the formal sense that the latter term is used in the Code, discussion of which will occur at the end of this column.

This definition of investment in the contract looks comparable to that of premiums paid under section 7702(f)(1) using only the first of its four listed reduction items. However, the two definitions differ in their treatment of contract exchanges covered by section 1035. As previously noted, section 7702(f)(1) premiums paid concept includes the value received from the replaced contract, but not so the section 72(e)(6) investment in the contract. Because section 1035 confers tax-free status on the exchange, the investment in the contract given up in the exchange is said to “carry over” to the new contract, so that the investment in the contract issued in the exchange starts with the investment in the old contract (the premiums previously paid for it less any untaxed distributions from it) and then is increased by any premiums paid for the new contract less any untaxed distributions from the new contract.

Another instance of a difference arises where a loan, assignment or pledge is made under a MEC, for that can trigger gain recognition under section 72(e)(4)(A). In such a case, the investment in the contract is increased by the amount includible in income, although the section 7702(f)(1) premiums paid remains unaffected.¹¹ It is important for insurance company tax monitoring and reporting systems to take these differences into account.

The treatment of premiums paid or charges made for benefit riders to contracts, as well as the treatment of the benefits paid under certain riders, also can play a role in determining the investment in the contract and may affect the section 7702(f)(1) premiums paid. One question currently under consideration by the Internal Revenue Service (IRS) and the Treasury Department, as disclosed in their Priority Guidance Plan, is the effect that benefit payments made under a qualified long-term care rider to an annuity contract have on the investment in the contract. Such payments may be income-tax free to the recipient, and to the extent they are, they could be viewed as untaxed distributions that, as a general matter, reduce the investment in the contract. These payments are unusual, however, in that they contain a pure insurance element and thus consist only partly of premiums previously paid for the contract. It remains to be seen what the government will say on this topic. The manner in which premiums and charges for benefit riders and benefit payments from them should be accounted for under sections 7702 and 72 is a voluminous subject that extends well beyond the scope of an “In the Beginning” column, but it is a subject worthy of in-depth study by those charged with tax compliance duties.

Life insurance and annuity contracts, as noted at the outset, also may be sold or may be exchanged in a taxable transaction (*i.e.*, where section 1035 does not apply). In the sale situation, a provision in section 72 speaks to adjustment of the investment in the contract in the hands of the new owner, a/k/a the buyer. Specifically, section 72(g) says that where a “transfer for value”

of a life insurance or annuity contract has occurred and there is not a “carry over” of the basis (see below) that existed in the hands of the former owner (the seller), the buyer’s investment in the contract consists of the “actual value of [the] consideration” paid by the buyer to acquire the contract plus any premiums or other consideration the buyer paid post-acquisition. Also, in determining the reduction of the investment in the contract by untaxed distributions, only those received by the buyer are factored into the buyer’s investment; untaxed amounts received by the seller are irrelevant for this purpose, although not for the seller’s own taxation, as discussed below.

In this connection, we may note that a rule parallel to section 72(g) exists in section 101(a)(2), the “transfer for value” provision that typically is more familiar to denizens of the life insurance industry. Section 101(a)(2) does not use any of the talismanic words otherwise considered here, but describes the treatment of a life insurance contract sale in the hands of the buyer in straightforward terminology. In plain English, it limits the exclusion of life insurance death proceeds otherwise allowed by section 101(a)(1) to the same amount that section 72(g) says is the buyer’s investment in the contract. Thus, the death proceeds above that amount are taxable to the buyer as ordinary income. It is section 101(a)(2)(A) that references the “carry over” of basis mentioned above, providing that a transfer for value limitation does not apply where the basis of the new owner is determined by looking to the basis of the former owner.

Apart from section 72(g), the concept that most comes into play in a contract sale setting, as well as in the case of a taxable exchange,¹² is formally called “basis.” In this sense, basis (sometimes called tax basis) serves as a determinant of taxable gain in circumstances in which an amount is not received under a contract in the sense of section 72 but rather is realized outside of it, as where a seller of a contract receives payment from a buyer or where the gain existing in a contract at the time of a taxable exchange is deemed to be realized by the policyholder. In these circumstances, the taxable gain that must be recognized under section 1001 (not section 72) equals the amount received (or deemed to be realized) in excess of the seller’s or policyholder’s basis. Such basis is technically determined under section 1012 (generally referencing the “cost of the property”), subject to adjustment as provided in section 1016.

As such, the calculation of the basis of a life insurance or annuity contract generally follows the same rules that determine the investment in the contract under section 72. Even so, there can be differences. One such difference that the IRS has fairly recently insisted on is that the basis of a life insurance contract should be adjusted downward to account for the cost of insurance.¹³ This is not done in determining the investment in the contract, and not surprisingly, the IRS’s view has been roundly criticized by life insurers, contract sellers, and contract buyers

(i.e., the life settlement industry), and legislation has been proposed in Congress to reverse the agency’s position.

By way of conclusion, in this column we have “scratched the surface” of the tax law’s rules governing premiums paid, investment in the contract, and basis. The purpose here has been to provide the reader with some basic definitions of these concepts and, importantly, to identify instances where they differ from one another even though they may appear to look alike. Much more can be said about this subject, and perhaps one of the readers of this column will one day provide us with instruction that delves into additional details. ■

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

ENDNOTES

- 1 To simplify matters, all references to “section” should be read as referring to sections of the Internal Revenue Code of 1986, as amended (Code or IRC).
- 2 This is the case even if we do not know that the notion of a “premium” dates back at least to the Renaissance and is based on the extra charge (a premium rate, if you will) paid by marine shippers of cargo to assure that the sinking of a ship carrying their cargo would not result in financial loss to them.
- 3 IRC section 7702(f)(1). Congress also told each insurance company to include premiums in calculating its own gross income, without much definition of the term apart from the need to follow, more or less, the reporting used in the company’s NAIC-prescribed annual statement. See IRC sections 803(a), 811(a).
- 4 The contract could, alternatively, meet the IRC section 7702 definition by complying with the cash value accumulation test, but only if it complies with that test by its terms.
- 5 Note that policyholder dividends retained by the insurer to pay premiums for a MEC are not treated as income pursuant to IRC section 72(e)(4)(B).
- 6 More detail concerning these rules can be found in chapter 4 of *DesRochers et al., Life Insurance & Modified Endowments, Second Edition* (Society of Actuaries 2015).
- 7 The reader should not view this statement as diminishing the significance of this rule as a device for saving contracts from non-compliance with the guideline premium test. See *DesRochers et al*, supra note 6, at 30–31.
- 8 We will now cease apologizing for the congressional redundancy.
- 9 See IRC section 72(e)(4)(A).
- 10 A companion definition for annuitized payments appears in IRC section 72(c).
- 11 A subsequent payoff of the loan or release of the assignment or pledge has no effect on the investment in the contract.
- 12 While most contract exchanges will be structured so that they are covered by IRC section 1035 and are thus income-tax free, not all can be. For example, if a jointly owned contract is subsequently divided via an exchange such that each former joint owner holds his or her own contract (albeit a smaller one than before), IRC section 1035 would not apply. The same would be true of a joint and last survivor contract that was divided, in effect, between the two insureds. Also, in *Rev. Rul. 90-109, 1990-2 C.B. 191*, the IRS concluded that a change of the party insured under a business-owned contract pursuant to a change-of-insured rider constituted a taxable exchange under IRC section 1001.
- 13 See *Rev. Rul. 2009-13, 2009-21 I.R.B. 1029*.

Recent IRS Rulings Highlight Investor Control Issues for Fund of Funds Arrangements

By John T. Adney and Bryan W. Keene

The opinion issued two years ago by the United States Tax Court in *Webber v. Commissioner of Internal Revenue*¹ seems to have reinvigorated interest in the “investor control” doctrine among insurance and investment professionals (the tax professionals, of course, had never stopped worrying over it). But starting long before then and continuing to date, life insurers and the managers of the funds supporting their variable products have demonstrated a steady desire to comply with the doctrine, as evidenced in the many private letter rulings they have sought from the Internal Revenue Service (IRS).

By way of background, the investor control doctrine may be described as the proposition, articulated by the IRS in a series of revenue rulings dating back to 1977, that the owner of a variable life insurance or annuity contract who controls the selection and disposition of the life insurer’s separate account assets supporting the contract is treated as owning those assets for federal income tax purposes. The result in such a case is that the contract owner is currently taxable on the income and realized gains from those assets.²

What’s more, the impermissible control by the contract owner may be indirect as well as direct. For example, the ability to allocate policy values among publicly-available funds—meaning funds in which a person can invest without purchasing an insurance contract—can constitute investor control under the IRS rulings.³ This is the case even though the contract owner has no input into the assets in which the publicly-available funds are invested or the insurer’s decision to make the publicly-available funds available as investment options under a variable contract.⁴ Because the impermissible control can be indirect, ascertaining the doctrine’s boundaries can be difficult and open to debate, and yet crossing the line may trigger a material tax liability that no one expected to incur. In its opinion in *Webber*, the Tax Court accorded the IRS’s rulings “Skidmore deference,”⁵ meaning the court would give credence to the IRS’s long-standing position in and of itself,



although the court also stated that it would have found the taxpayer to have owned the separate account assets based on an independent analysis of the tax law’s precepts of property ownership.

While the IRS had not published official guidance on the investor control doctrine in almost a decade prior to *Webber*, the agency has consistently spoken to the doctrine’s contours in responding to a significant number of private letter ruling requests from insurers and fund managers. And within the past decade, many of those requests, and the rulings issued in response, dealt with the concern that indirect investment in publicly-available funds could, depending on the structure employed, fall on the wrong side of the doctrine. Three recent private letter rulings, the subject of this article, represent a continuation of this trend.

Specifically, late in 2016 the IRS released PLRs 201651002 and 201651012,⁶ followed by the release of PLR 201705003 earlier this year,⁷ addressing the investor control doctrine in the context of insurance-dedicated funds of funds.⁸ The IRS concluded that, for federal income tax purposes, the life insurance company that invests in each top-level, insurance-dedicated fund described in the rulings would be treated as the owner of the fund, *i.e.*, the investor control doctrine would not apply.

PLRs 201651002 AND 201651012

In PLRs 201651002 and 201651012, which are substantively identical, the IRS was asked to delineate the treatment of an insurance-dedicated fund, denominated the “Portfolio” in the rulings. The Portfolio represented a new series of a “Fund,” which was organized as a business trust registered under the federal securities laws. The Portfolio elected to be classified as a partnership for tax purposes and, because it was insurance-dedicated, qualified for look-through treatment under the IRC section 817(h) regulations.⁹

According to the rulings, variable contract owners will be able to allocate amounts under their contracts to an investment option that corresponds to the Portfolio, and the insurance company’s separate account will then invest in the Portfolio. Further, the Portfolio will invest substantially all of its assets in “Underlying Funds” consisting of “a variety of eligible third-party mutual funds, other third-party variable insurance investment options, or both.” Although the rulings are not explicit on the point, this reference to mutual funds appears to mean publicly-available mutual funds as distinguished from insurance-dedicated funds or managed separate accounts, which appear to encompass the rulings’ reference to “variable insurance investment options.”

Importantly, the Portfolio’s investment manager (who was affiliated with the issuing insurer) will make investment decisions for the Portfolio in its sole and absolute discretion, without notice to or approval by the contract holders. While the Portfolio’s allocations between debt and equity asset classes would be expected to fall within certain ranges identified in the rulings (the details of which were redacted in the rulings as released to the public), the rulings indicate that the allocations to particular Underlying Funds will change over time and there could be no expectation that current or past positions in any Underlying Fund will be maintained in the future. Also important to the IRS’s conclusions, the rulings recite that a contract holder “will have no current knowledge of [the] Portfolio’s specific assets,” although information about the Portfolio’s holdings would be available in SEC filings and reports to shareholders. The rulings also recite certain other facts consistent with the facts in Revenue Ruling 2003-91,¹⁰ such as the absence of an agreement with a contract owner regarding particular investments of the Portfolio and the inability of an owner to direct investment in a particular asset or to recommend a particular investment or investment strategy.

After summarizing the investor control doctrine, the IRS in PLRs 201651002 and 201651012 concluded that for federal income tax purposes the life insurance company and not the variable contract holder “is the owner of [the] Portfolio and its underlying investment assets.” In its discussion of the rationale for the rulings, the IRS, after emphasizing that application of

the investor control doctrine depends on all the facts and circumstances, concluded that the contract owners “do not have any control over [the] Portfolio’s investments, including [the] Portfolio’s investments in the Underlying Funds.” The agency also pointed to the facts that the investment decisions for the Portfolio would be made by the investment manager in its sole and absolute discretion and that it could change the investments without notice to or approval by the owners. Hence, according to the IRS, the Portfolio “is not an indirect means of allowing a variable contract holder to invest in an Underlying Fund.”

PLR 201705003

PLR 201705003 involved three Portfolios that were formed as series of a state statutory trust (the “Trust”). According to the ruling, each Portfolio is or will be an insurance-dedicated regulated investment company and will correspond to an investment option under variable contracts purchased by individuals. Each Portfolio has an investment strategy that involves allocations among various asset classes in specified percentages. The Portfolios will gain exposure to those asset classes by investing in other regulated investment companies. In other words, each Portfolio will be a fund of funds. The lower-tier funds generally will include other insurance-dedicated funds that are series of the Trust as well as publicly-available funds.

Two of the Portfolios will allocate specified percentages of their assets among five different asset classes. The asset classes are the same for the two Portfolios, but the percentages allocated to each class appear to differ between them (presumably one Portfolio is more conservative than the other). These two Portfolios will achieve their desired asset allocation mixes by investing in “equity and fixed income passive index regulated investment companies,” with a specified percentage of each Portfolio’s allocations being to publicly-available funds.

The third Portfolio will invest specified percentages of its assets between two asset classes. It will gain exposure to the asset classes by investing in other insurance-dedicated funds or publicly-available funds “that seek to sample, but not replicate, the performance of third-party indices.” The ruling does not say whether a particular percentage of those lower-tier funds are expected to be publicly available. In any event, to the extent that the ruling says specific percentage allocations among asset classes or publicly-available funds are expected for any of the Portfolios, the percentages themselves were redacted from the ruling.

An “Adviser” provides investment advisory services to the Trust. The ruling recites several facts regarding the Adviser’s role and the policyholder’s inability to direct a Portfolio’s investments. In particular: (1) all investment decisions for each Portfolio will be made “solely by Adviser,” (2) a policyholder “will not

be able to direct a Portfolio's investment in any particular asset or asset class" or "recommend a particular investment or investment strategy," and (3) there will be no agreement or plan with any policyholder "regarding a particular investment" of any Portfolio. The ruling also recites several facts regarding a policyholder's current or advance knowledge of a Portfolio's holdings: (a) the percentage of a Portfolio's assets invested in a particular lower-tier fund will not be "legally fixed" in advance of any policyholder's allocation to the Portfolio, (b) the percentages allocated to any particular lower-tier fund will be subject to change by the Portfolio's board at any time, and (c) as in the two prior rulings described above, a policyholder will have "no current knowledge of a Portfolio's specific asset composition," although each Portfolio's holdings will be available "as permitted by the SEC."

An insurance-dedicated fund that is a "clone" of a publicly-available fund can present the question of whether the insurance-dedicated fund might be deemed to be publicly available in violation of the investor control doctrine ...

After summarizing the investor control doctrine, PLR 201705003 notes that determinations under the doctrine depend on "all the relevant facts and circumstances." The ruling then concludes that, under the facts presented, the policyholders "do not have any control of the investments of the Portfolios, including the ... investment in public ... funds." The ruling then specifically focuses on the facts that the investment decisions for a Portfolio are made by the Adviser "in its sole and absolute discretion" and are "subject to change without notice to or approval by" the policyholders. The ruling also concludes that the policyholders do not have any more control than was the case in Revenue Ruling 82-54 or Revenue Ruling 2003-91, and that the Portfolios "are not an indirect means of allowing a [policyholder] to invest in public funds." Thus, based on the representations and facts presented, the ruling concludes that "each of Portfolio A, B and C's investments will not cause the [policyholders] to be treated as the owners of a Portfolio for federal income assets [sic] purposes."¹¹

CONCLUDING THOUGHTS

The IRS has issued numerous private letter rulings over the years addressing the investor control implications of insurance-dedicated funds of funds.¹² Although not expressly discussed in the rulings, many appear to involve facts that are analogous to those involving "clone" funds, *i.e.*,

insurance-dedicated and publicly-available funds that have identical (or nearly identical) holdings. An insurance-dedicated fund that is a "clone" of a publicly-available fund can present the question of whether the insurance-dedicated fund might be deemed to be publicly available in violation of the investor control doctrine by virtue of a policyholder's ability to achieve the same investment result by investing in either an insurance-dedicated fund or its publicly-available clone. Conceivably, a similar question could arise even in the absence of a clone fund if the policyholder can readily replicate the insurance-dedicated fund's holdings.

The facts of the past rulings that seem most relevant to the investor control analysis and that may have led previous taxpayers to seek those rulings include (1) varying degrees of active *versus* passive management of the underlying portfolios of lower-tier funds, (2) the extent to which the lower-tier funds would include publicly-available mutual funds *versus* insurance-dedicated funds, (3) the amount and timing of information available to the policyholders regarding the composition of the underlying portfolio of lower-tier funds, and (4) similarities and differences between the insurance-dedicated fund of funds and a publicly-available version of the same fund of funds.¹³

The Portfolios involved in the three recent private letter rulings summarized above appear to present some of these same factual issues. For example, PLRs 201651002 and 201651012 recited that the contract owners would have "no current knowledge" of the specific assets underlying their contracts, that the portion of a Portfolio's assets allocated to any particular lower-tier fund will change over time, and that there could be no expectation of current or past positions in any particular lower-tier fund being maintained in the future. These facts speak to a policyholder's ability to replicate a Portfolio's holdings.¹⁴

Similarly, in PLR 201705003 the taxpayer informed the IRS that a policyholder will have "no current knowledge of a Portfolio's specific asset composition," and that the percentage of a Portfolio's assets invested in a particular lower-tier fund will not be "legally fixed" in advance of any policyholder's allocation to the Portfolio. The ruling further states that each Portfolio will invest in "passive index" regulated investment companies, some of which "seek to sample, but not replicate, the performance of third-party indices." These facts also speak to a policyholder's ability to replicate a Portfolio's holdings.¹⁵

The IRS's published guidance on investor control does not mention these types of facts or explicitly identify a concern over a policyholder's ability to replicate the holdings of an insurance-dedicated fund. The discussion of such facts in the three recent private letter rulings (and those preceding them)

nonetheless suggest a concern, at least by the taxpayers, that an investor control issue could arise if an insurance-dedicated fund's holdings were so fixed and easily replicated that the fund, in effect, is also available for direct investment by members of the general public. In that regard, it is interesting to note that the IRS specifically concludes in each of the recent rulings that the Portfolios are not indirect means of allowing a policyholder to invest in publicly-available funds.

Overall, the IRS's recent rulings on the fund of funds arrangements represent relatively straightforward applications of the investor control doctrine. Despite the presence of certain facts suggesting some concern that the funds might be deemed to be publicly available, the taxpayers presented various other facts that aligned specifically with those in Revenue Ruling 2003-91. That ruling recites various facts and concludes that the investor control doctrine does not apply, which makes the ruling a safe harbor of sorts—or at least a helpful roadmap—for avoiding investor control problems. By aligning their facts to those in the 2003 revenue ruling as much as possible, the taxpayers seeking the recent private letter rulings helped ensure their favorable outcomes. For example, the taxpayers presented facts showing that the contract owners had no input into the investment strategy or investment decisions of the Portfolios, and that the Portfolios' investment advisers retained full discretion over all investment decisions. Such facts would seem to remain critical to finding a lack of impermissible investor control.

In addition, the IRS concluded in PLRs 201651002 and 201651012 that the insurance company would be treated as owning the Portfolio and the Portfolio's "underlying investment assets" for federal income tax purposes. The Portfolio, however, had elected to be taxed as a partnership, and the insurance company technically would be purchasing an interest in the partnership. If taken literally, the conclusion of these rulings could mean that for all federal income tax purposes the life insurance company is treated as owning each asset of the partnership, rather than owning an interest in the partnership itself. Although the look-through rule in Treas. Reg. section 1.817-5(f)(1) treats the assets of an insurance-dedicated partnership as assets of a segregated asset account, such treatment is limited to the section 817(h) diversification requirements. It is not clear whether the IRS intended for the conclusion in these two rulings regarding the ownership of the partnership's assets to apply for income tax purposes beyond the IRC section 817(h) diversification requirements.

As a final point, turning back to the *Webber* case, it is interesting that none of the new rulings made any mention of the Tax Court's opinion in that case. Perhaps the IRS concluded that the court's holding on the extreme facts presented in that litigation was not all that pertinent to the situation of the taxpayers requesting the new rulings. ■

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com.

Bryan W. Keene is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at bwkeene@davis-harman.com

ENDNOTES

- 1 144 T.C. 324 (2015). For further discussion of the *Webber* case, see Ann Cammack and Frederic J. Gelfond, "Investor Control: Will You Know it When You See it?" *TAXING TIMES*, March 2016, Vol. 12, No. 1, at p. 36.
- 2 In other words, the non-taxation of the contract's inside buildup is lost. Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12.
- 3 See, e.g., Rev. Rul. 81-225, *supra* note 2.
- 4 See, e.g., PLR 201519001 (Oct. 10, 2014).
- 5 *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).
- 6 Sept. 14, 2016.
- 7 Oct. 27, 2016.
- 8 An insurance-dedicated fund is a regulated investment company, real estate investment trust, partnership, or grantor trust that qualifies for look-through treatment under the section 817(h) regulations because (1) all beneficial interests in the entity are held by segregated asset accounts of insurance companies, and (2) public access to the entity is available exclusively through the purchase of a variable contract. See Treas. Reg. section 1.817-5(f).
- 9 See *id.*
- 10 Cited in note 2, *supra*.
- 11 The ruling also discusses the application of the excise tax under section 4982 to the Portfolios. That section imposes an excise tax on regulated investment companies ("RICs") that do not satisfy certain requirements relating to distributions of their income to shareholders. An exception to the excise tax exists under section 4982(f) for RICs whose shareholders are limited to life insurance company segregated asset accounts in connection with variable contracts. The IRS has recognized, as it did in PLR 201705003, that the potential application of this excise tax gives a RIC procedural standing to request a private letter ruling on investor control issues affecting the RIC. See, e.g., PLR 201540004 (June 29, 2015). Because the IRS concludes in this case that the policyholders will not be treated as owning the Portfolios for federal income tax purposes, the ruling also concludes that "each Portfolio will be eligible for the exception from the excise tax imposed by section 4982."
- 12 See, e.g., PLR 201540004 (June 29, 2015); PLR 201417007 (Dec. 19, 2013); PLR 201014001 (Dec. 8, 2009); PLR 200952009 (Sept. 16, 2009); PLR 200938018 (June 29, 2009); PLR 200938006 (June 29, 2009); PLR 200915006 (Dec. 23, 2008); PLR 200601006 (Sept. 30, 2005); PLR 200420017 (Feb. 2, 2004); PLR 200025037 (Mar. 24, 2000); PLR 9851044 (June 30, 1998); PLR 9839034 (June 30, 1998); and PLR 9748035 (Aug. 29, 1997).
- 13 See the rulings cited in note 12, *supra*.
- 14 See also PLRs 201540004 and 201014001, cited in note 12, *supra*, which noted this factor as part of the IRS's analysis.
- 15 Although not discussed in the ruling, the fact that the Portfolios also planned to invest in other insurance-dedicated funds, which themselves are not publicly available, could contribute to the uniqueness of the mix of assets held in the Portfolios, further distinguishing them from pure clones of publicly-available funds of funds.

ACLI Update

By Pete Bautz, Mandana Parsazad and Regina Rose

JOINT COMMITTEE ON TAXATION UPDATES ITS LIST OF TAX EXPENDITURES

On Jan. 30, 2017, the Joint Committee on Taxation (JCT) updated its tax expenditure list to, among other things, add as a tax expenditure “amounts received under a life insurance contract that are paid by reason of the death of the insured.” JCT estimates the revenue cost of this item as \$128.3 billion over five years, \$116.7 billion of which is attributed to individual taxpayers and \$11.6 billion attributed to corporate taxpayers.

By way of context, among the most expensive tax expenditures in JCT’s 2016–2020 list are the items shown in Table 1.

Inclusion of death benefits in the list is not a surprise. The JCT removed inside build-up from its list of tax expenditures for fiscal years 2015–2019 in December 2015, noting that it did not meet the definition of a tax expenditure under the Congressional Budget and Impoundment Control Act of 1974 (Budget Act). In the same report, they wrote that “it may be appropriate to include a tax expenditure estimate of the exclusion from gross income of death benefits payable under a life insurance contract by reason of the death of the insured,” presumably because a specific provision of federal tax law provides an exclusion for that item from income, thus meeting the definition of a tax expenditure under the Budget Act.

Table 1

JCT Tax Expenditure	2016 -2020 Projected Cost (billions)
Deferral of income of controlled foreign corporations	587.2
Mortgage interest deduction	357.0
Lower tax rates on dividends and capital gains	677.7
Exclusion of employer contributions for health care	863.1
Defined benefit plans	424.3
Defined contribution plans	583.6
Earned income tax credit	373.4
Total of these tax expenditures	3,866.3

ACLI and its member companies have developed sound tax policy arguments as to why the current exclusion of death benefits from income should continue. We will continue to study the issue to determine how best to address this change.

Finally, the life insurance-related items from previous years continue to remain on the list with the updated revenue estimates shown in Table 2.

SENATOR CARDIN’S PROGRESSIVE CONSUMPTION TAX ACT OF 2016

In late December 2016, Senator Ben Cardin (D-MD) introduced the Progressive Consumption Tax Act of 2016 (Bill). The Bill is substantially similar to the Progressive Consumption Tax Act of 2014 in its structure, with significant improvements concerning the treatment of insurance companies and products. ACLI provided comments to Senator Cardin’s staff on the prior bill, which exempted financial supplies, such as life insurance and annuity contracts, from the consumption tax. We requested they provide a partial input credit for insurance companies so the consumption tax is not passed onto insurance customers in the form of a “hidden” cost.

The 2016 Bill also provides an exemption from the consumption tax for financial supplies, such as insurance and annuity contracts. Senator Cardin and his staff were responsive to our request for partial input credits. The Bill provides for a 60 percent input credit for the consumption taxes paid on goods and services used to develop insurance and annuity contracts. Goods and services used to develop insurance and annuity contracts are defined as partially creditable acquisitions, and include insurance services and brokerage services. Other creditable acquisitions include:

- Banking or cash management services, including services related to issuing, closing, operating, and maintaining accounts, and the processing of account information and applications;

Table 2

	Five Year Revenue Estimate (billions)
Special treatment of life insurance company reserves	16.5
Small life insurance company taxable income adjustment (The estimate for each year is a “positive tax expenditure of less than \$50 million,” which is below the de minimis amount.)	Not Available
Exclusion of premiums on group term life insurance	21.5
Exclusion of premiums on accident and disability insurance	23.1
Treatment of loans under life insurance and annuity contracts and 401(k) plans	Not Available
Plans covering partners and sole proprietors—Keogh plans	63.0
Defined benefit plans	424.3
Defined contribution plans	583.6
Traditional IRAs	85.8
Roth IRAs	44.6
IRA Contributions	7.0
Total of these 5 Year Revenue Estimates	1,269.4

- Payment and fund transfer services, including for the operation of a payment system and processing account transactions;
- Securities transaction services for the provision, acquisition, or disposal of an interest in a security;
- Loan and debt collection services, including mortgage brokerage services, services related to mortgage insurance and loan protection insurance, and loan application, management, and processing services; and
- Capital markets, financial instruments, or fund management services.

The Bill allows for regulatory guidance on additional items that may qualify as creditable acquisitions.

More generally, the Bill reduces the corporate income tax rate to 17 percent. Individual income tax rates are reduced to three brackets of 15 percent, 25 percent, and 28 percent, with an exemption (“family allowance”) of \$100,000 for joint filers, \$50,000 for single filers, and \$75,000 for head of household filers. The consumption tax is applied at a 10 percent rate. A cap is placed on how much is raised by the consumption tax on an annual basis. The cap, called a “circuit breaker,” requires that any consumption tax revenues in excess of 10 percent of the gross domestic product in a calendar year be refunded to all individual income tax filers, including those taxpayers who have filed for a consumption tax rebate.

The House Ways & Means Tax Reform Blueprint contains consumption tax elements insofar as it aims to impose a tax at the source of consumption. Thus, although the idea of a value-added tax has long been rejected as a possible source of revenue in the U.S., serious consideration of novel approaches to taxation such as the Blueprint suggest that a serious discussion of a consumption tax—albeit by a name other than a value-added tax, or “VAT”—is worthwhile. To that end, ACLI and its member companies continue to analyze this revised Bill to assess its impact on our industry.

REPRESENTATIVES TIBERI AND KIND INTRODUCE BILL TO REQUIRE TAX INFORMATION REPORTING FOR SALES OF LIFE INSURANCE POLICIES

On Feb. 28, 2017, Representatives Pat Tiberi (R-OH) and Ron Kind (D-WI) introduced HR 1262, a bill “To amend the Internal Revenue Code of 1986 to clarify the tax treatment of certain life insurance contract transactions, and for other purposes,” which essentially requires tax information reporting for sales of life insurance contracts. It establishes reporting requirements for acquisitions of life insurance contracts in a reportable policy sale, which is defined as “the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest in such life insurance contract.” In this regard, the definition appropriately carves out transfers of life insurance policies that occur in the context of business continuity and family estate planning.

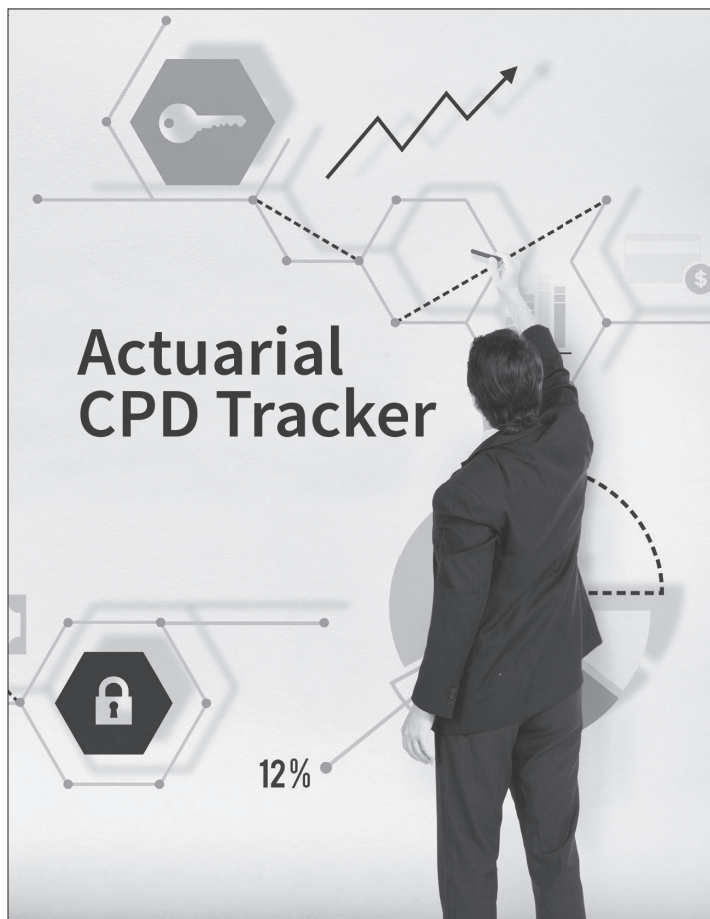
Regarding tax information reporting, under the bill, purchaser of any life insurance policy must report the sale (including identity of the policyholder/seller and policy information) to the Internal Revenue Service (IRS) and the insurance company that issued the policy, and provide the amount of the sale to the IRS. Such a report notifies the life insurance company that issued the sold policy of its obligation to provide other specified details. The insurance company must provide the policyholder/seller's basis in the contract to the policyholder as well as to the IRS. In furnishing this report, the bill confirms that no basis adjustment shall be made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract. The insurance company must also report any subsequent payments of death benefits on the sold policy to the IRS, and the new policy owner.

The bill captures the changes ACLI and other trade associations suggested to a bill introduced by Senator Casey in past congresses that required similar reporting of life settlement transactions, and has ACLI's support. ■

Pete Bautz is senior vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at petebautz@acli.com.

Mandana Parsazad is vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at mandanaparsazad@acli.com.

Regina Rose is vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at reginarose@acli.com.



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T³: *TAXING TIMES* Tidbits

Proposed Regulations Refine “Net Premiums Written”

By Jean Baxley

Section 9010(b) of the Patient Protection and Affordable Care Act (ACA) requires the Secretary to determine the annual health insurer fee for each covered entity based on the ratio of the covered entity’s net premiums written to the aggregate premiums written by all covered entities.¹ Section 9010 does not define the term “net premiums written.”

Current regulations (TD 9643; 78 FR 71476 (Nov. 29, 2013)) define net premiums written as premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions and medical loss ratio (MLR) rebates with respect to the data year. Treas. Reg. § 57.2(k).

Comments received by the IRS and Treasury have requested (1) clarification that premium adjustments related to retrospectively rated contracts be taken into account in determining a covered entity’s net premiums written and (2) clarification regarding the treatment of risk adjustment payments under Section 1343 of the ACA.

Proposed regulations released in December 2016 address these comments, and also impose an electronic filing requirement for IRS Forms 8963. Prop. Reg. § 57.2 (REG-134438-15 (Dec. 9, 2016)) would refine the definition of net premiums written; Prop. Reg. § 57.3 (REG 123829-16 (Dec. 9, 2016)) would require electronic filing of Form 8963 for certain health insurers. These proposed regulations would apply to any fee that is due on or after Sept. 30, 2018, and any Form 8963 filed after Dec. 31, 2017 for covered entities reporting more than \$25 million in net premiums written.

PROP. REG. § 57.2

1. Retrospective Premium Adjustments

To mitigate covered entities bearing a liability for premiums for which they do not receive an economic benefit, the net premiums written definition would address premium adjustments related to retrospectively rated contracts, computed on



an accrual basis. These amounts are received from policyholders (“retrospectively rated contract receipts,” which increase net premiums written) and paid to policyholders (“retrospectively rated contract payments,” which decrease net premiums written) annually based on the loss experience of the insured during the policy period. Prop. Reg. § 57.2(k)(2)(iii). Retrospectively rated contract receipts and payments do not include changes to funds or accounts that remain under the control of the covered entity, such as changes to premium stabilization reserves.

2. Risk Adjustment Payments and Charges

The proposed regulations clarify that a covered entity’s “net premiums written” includes risk adjustment payments received under Section 1343 of the ACA and is reduced for risk adjustment charges paid under Section 1343 of the ACA. Prop. Reg. § 57.2(k)(2)(iv).²



Regardless whether a covered entity includes risk adjustment payments received as direct premiums written on its Supplemental Health Care Exhibit (SHCE), or does not file an SHCE, these risk adjustment payments and charges are included in the net premiums written computation and must be reported on Form 8963. Risk adjustment payments received and charges paid are computed on an accrual basis.

3. Reinsurance Premiums

The proposed regulations revise headings to emphasize that assumption reinsurance premiums are included in net premiums written and ceded premiums for assumption reinsurance reduce net premiums written, but that premiums for indemnity reinsurance are excluded from net premiums written because “indemnity reinsurance ... is not health insurance ...” This rule is designed to prevent double-counting of premiums related to the same health insurance coverage.

4. IRS Authorized to Publish Additional Guidance

The proposed regulations authorize the IRS to publish additional guidance in the Internal Revenue Bulletin, rather than through additional amendments to the regulations, to provide rules for additional adjustments to premiums written in determining net premiums written. Prop. Reg. § 57.2(k)(2)(v). This authorization should facilitate timely responses to emerging questions and issues regarding computation of net premiums written.

PROP. REG. § 57.3

1. Electronic Filing of Form 8963

Proposed regulations provide that a covered entity (including a controlled group) reporting more than \$25 million in net premiums written on a Form 8963 or corrected Form 8963, *i.e.*, covered entities that are fee payers, must electronically file these forms after Dec. 31, 2017 (for the 2018 fee year). Failure to electronically file will be treated as a failure to file for purposes of §57.3(b). Electronic filing will not be required for Forms 8963 reporting \$25 million or less in net premiums written, *i.e.*, for health insurers that will not be required to pay a fee.

The notice of proposed rulemaking asserts electronic filing of Forms 8963 and corrected Forms 8963 would facilitate the administration of the fee by significantly reducing delays and the resources needed to calculate the preliminary and final fee amounts. This change in filing requirements should be helpful in light of the short turnaround between a taxpayer’s initial filing of Form 8963 (April 15), the IRS’s mailing the notice of preliminary fee (June 15), the due date for health insurer’s corrections (July 15), the IRS’s mailing the final fee calculation (August 31), and the due date for payment of the fee (September 30).

The health insurer fee is suspended for the fee year 2017.³ ■

Jean Baxley is managing director, Tax/Washington National Tax at Deloitte Tax LLP and can be reached at jebaxley@deloitte.com.

ENDNOTES

- 1 For more background on the annual health insurer fee, see “A Tax Like No Other: The Health Insurer Fee,” 11 *TAXING TIMES* 23 (Oct. 2015), by Jean Baxley, Mersini Keller, and Lori Robbins.
- 2 For a discussion of the ACA risk adjustment program, see “Reporting the Costs and Benefits of the 3R’s,” 11 *TAXING TIMES* 34 (June 2015), by Maureen Nelson, Matthew Haaf, and Megan Lansden.
- 3 Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, Div. P, §201 (Dec. 18, 2015). For more information see Frequently Asked Questions on the 2017 Moratorium on Health Insurance Provider Fee, https://www.cms.gov/CCIIO/Resources/Fact-Sheets-and-FAQs/Downloads/FINAL_9010_FAQ_2-29-16



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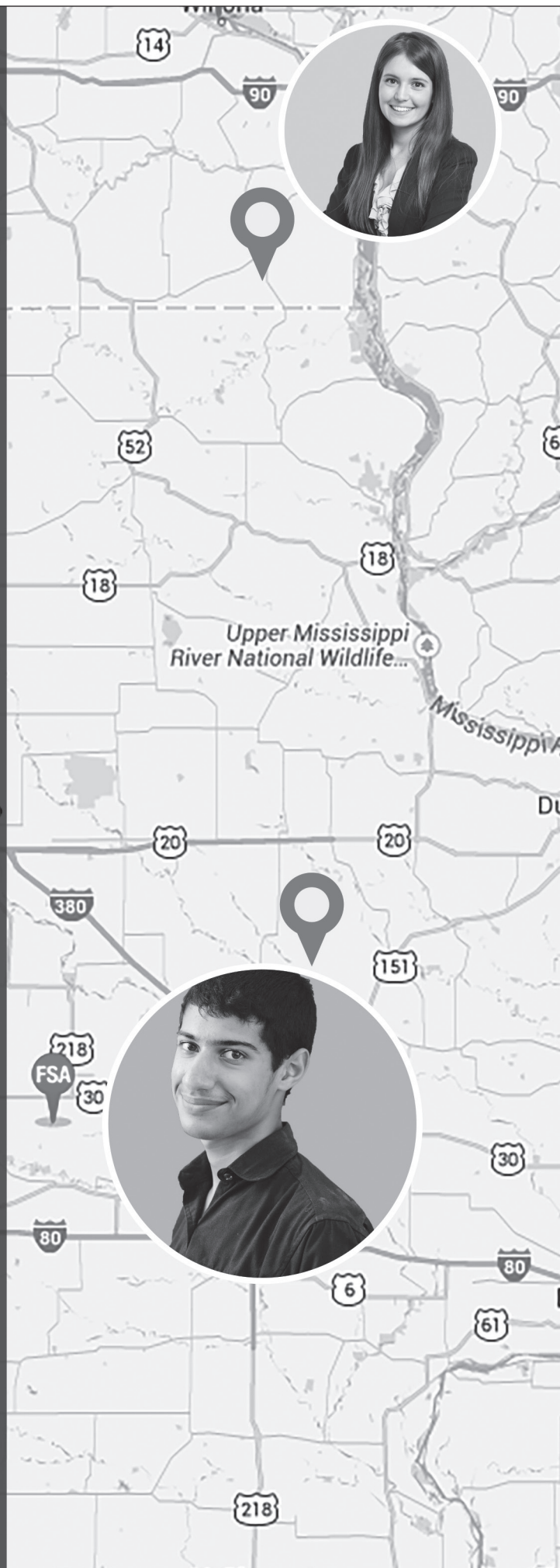
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