



The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Session I: Life Insurance Product Tax Update

Moderator:

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Presenters:

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2018 Product Tax Seminar

Life Product Update Session 1

September 13, 2018



SOCIETY OF ACTUARIES

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Presenters

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Overview

- The Tax Cuts and Jobs Act (TCJA) of 2017 amendments to Section 7702
- TCJA and Notice 2018-41: Reporting requirements for life settlements
- Revenue Procedure 2018-20: Guidance on post-age 100 calculations under Sections 7702 and 7702A
- Product tax considerations for the 2017 commissioners' standard ordinary (CSO) mortality tables

The TCJA Amendments to Section 7702



Background: The Section 7702 “Reasonable Mortality Charge” Rule



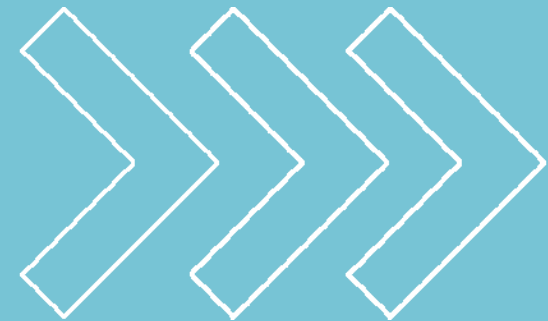
The Reasonable Mortality Charge Rule as Enacted by TAMRA

- The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) enacted the “reasonable mortality charge” rule of Section 7702(c)(3)(B)(i), applicable to contracts issued after October 20, 1988.
- The rule requires the calculation of guideline premiums and (via Section 7702(b)(2)(B)) net single premiums to 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.”
- The rule also applies to calculations under Section 7702A.

The Reasonable Mortality Charge Rule as Enacted by TAMRA (cont.)

- Section 5011(c)(2) of TAMRA provides an exception, known as the “interim mortality rule,” to address the application of the general rule prior to the issuance of regulations, which were required to be issued by January 1, 1990.
- The interim rule, intended particularly to help with contracts covering, for example, substandard risks, treats mortality charges “which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)” as satisfying the general rule.
- Since no regulations have been issued, the interim rule still applies.

The Reasonable Mortality Charge Rule as Amended by the TCJA



The Revised Reasonable Mortality Charge Rule

- The Tax Cuts and Jobs Act of 2017 (TCJA), in rewriting the life insurance reserve deduction rules, eliminated the Section 807(d)(5) definition of prevailing commissioners' standard tables.
- To preserve this defined term for use in the reasonable mortality charge rule, the TCJA moved it and a companion three-year transition rule into new Section 7702(f)(10), clarifying that the applicable tables are those prevailing at the time of contract issuance.
- The TCJA also revised the reasonable mortality charge rule itself to require the Section 7702 and 7702A premium calculations to be based on "reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in [Section 7702(f)(10)]."

The Revised Reasonable Mortality Charge Rule (cont.)

- The TCJA thus revised the original version of the rule as follows (showing deletions made by the TCJA in strikethrough text and its additions in italics):

“reasonable mortality charges which meet the requirements ~~(if any)~~ prescribed in regulations *to be promulgated by the Secretary* ~~and which (except as provided in regulations)~~ *or that* 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~~ *subsection (f)(10).*”

- These changes are effective for taxable years after December 31, 2017, which is the general effective date for the changes in the reserve deduction rules.

The Revised Reasonable Mortality Charge Rule (cont.)

- As a result of the TCJA's changes, the reasonable mortality charge rule can be read as consisting of two elements, compliance with either of which is sufficient:
 - (1) Reasonable charges which meet the requirements prescribed in regulations to be promulgated by the Secretary, or
 - (2) Reasonable charges that do not exceed the mortality charges specified in the prevailing commissioners' standard tables at the time the contract is issued.
- Accordingly, per (1) above, regulations still may be issued permitting the use of charges that exceed those based on 100% of the prevailing tables.
- However, per (2) above, the explicit grant of regulatory authority to limit reasonable mortality charges to amounts less than charges based on 100% of the prevailing tables was removed, although the charges still must be "reasonable" to be used in the calculations.

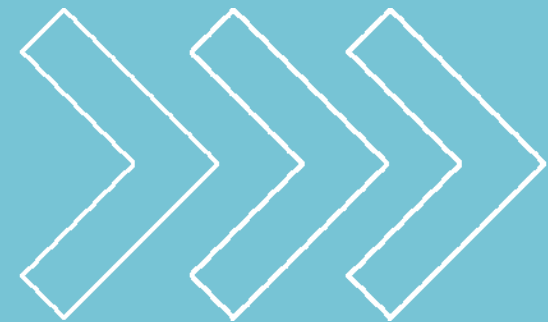
The Revised Reasonable Mortality Charge Rule (cont.)

- While the general effective date of the Section 7702 amendments is “taxable years after” December 31, 2017, the TCJA did not repeal the interim mortality charge rule, which is contained in the United States Statutes at Large.
- An earlier enacted statute is not considered repealed unless it is fully replaced or contradicted by a later enactment. See *Posadas v. National City Bank of N.Y.*, 296 U.S. 497, 503 (1936).
- The interim rule remains needed to give effect to the revised rule’s first element, relating to the use of charges exceeding those based on the prevailing tables until regulations are promulgated.

TCJA and Notice 2018-41: Reporting Requirements for Life Settlements



TCJA Reporting Requirements for Life Settlement Transactions



Life Settlement Reporting

- The TCJA added Section 6050Y(a) to the Code, which provides that every person who acquires, directly or indirectly, a life insurance contract (or any interest in such a contract) in a “reportable policy sale” must report:
 - The acquirer’s name, address, and TIN,
 - The name, address, and TIN of each recipient of payment in the reportable policy sale,
 - The date of such sale,
 - The name of the issuer and policy number of the contract sold, and
 - The amount of each payment.
- Similar information, including an information contact phone number, must be provided by the acquirer to the seller and issuer, but the amount of the payment need not be disclosed to the issuer.
- A “reportable policy sale” is defined in new Section 101(a)(3)(B) as an acquisition of an interest in a life insurance contract, directly or indirectly (such as through a partnership or trust), if the acquirer has no other substantial family, business, or financial relationship with the insured.

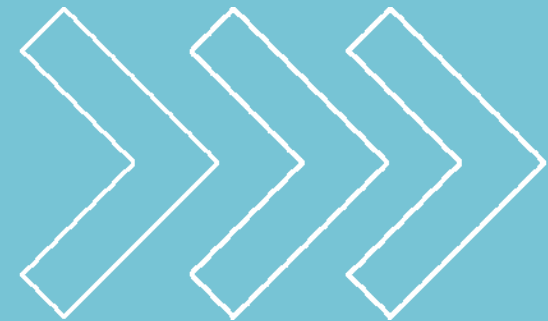
Life Settlement Reporting (cont.)

- Issuer reporting obligation upon transfer – Upon receipt of the statement, or upon notice of a transfer to a foreign person, the issuer must report to the IRS and seller:
 - The name, address, and TIN of the seller who transfers any interest in such contract in such sale,
 - The seller's investment in the contract (as defined in Section 72(e)(6)), and
 - The policy number of such contract.
- Issuer reporting obligation to others upon transfer – This same information, including an information contact, must be provided to the seller.
- Issuer reporting obligation for death benefit – Upon payment of a reportable death benefit, the name, address, and TIN of the payor and recipient, the date of payment, the gross amount of payment, and an estimate of the buyer's investment in the contract must be reported to the IRS and recipient.
- Tax penalties under Sections 6721 and 6722 apply to reporting failures.

Life Settlement Reporting (cont.)

- Adjusted Basis Clarification – The TCJA amended Section 1016(a)(1) to clarify that, in determining a taxpayer’s adjusted basis under Section 1011, no adjustments are made “for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.” This clarification reverses Rev. Rul. 2009-13.
- Transfer for value rule changes – The TCJA amended the exceptions to the transfer for value rule so that they do not apply to a reportable policy sale.
- Effective date – These changes generally apply to transfers after December 31, 2017, but the adjusted basis provision is effective for transactions entered into after August 25, 2009, which is the effective date of Rev. Rul. 2009-13.

Notice 2018-41: IRS Guidance on Life Settlement Transaction Reporting



Notice 2018-41: IRS Guidance on Life Settlement Transaction Reporting

- Announcement of intent to issue proposed regulations
- Expected content described in general terms
- Comments requested
- Observations:
 - “Issuer” is limited to the person responsible for administering the contract.
 - Issuer reporting of amount that would have been received by a policyholder on surrender.
 - Issuer must report the death benefit, regardless of whether a notice of a reportable policy sale was received.
 - “Investment in the contract” reported by issuer upon a reportable policy sale will be limited to information the issuer knows. A similar rule will apply with respect to the estimate of investment in the contract that must be reported with respect to reportable death benefits.
 - Transition rules and effective date delay.
- Draft IRS Forms 1099-LS and 1099-SB

Revenue Procedure 2018-20: Guidance on Post-Age 100 Calculations Under Sections 7702 and 7702A



Background on Post-Age 100 Guidance



Section 7702 and 7702A Calculations Post-100

- Limiting age of 121 under 2001 CSO tables (as under the 2017 CSO tables):
 - Section 7702(e)(1)(B) requires calculations to assume maturity between ages 95 and 100; Section 7702A follows this rule.
 - The 2001 Maturity Age Task Force of SOA Taxation Section published a report on maturity rule issues in *TAXING TIMES* in May 2006.
- Notice 2009-47 published in June 2009 listing eight *Age 100 Safe Harbor Testing Methodologies* adapted from task force report
- Rev. Proc. 2010-28 published in August 2010

Rev. Proc. 2010-28, 2010-34 I.R.B. 270

- Effective August 23, 2010
- Generally used *Age 100 Safe Harbor Testing Methodologies* from Notice 2009-47 (see next two slides)
- Stated, as insurance industry requested, that there is no adverse inference on Section 7702 qualification or MEC status if the safe harbor is not met

Rev. Proc. 2010-28 § 3.02 Safe Harbor Rules

- a) All Section 7702 and 7702A calculations assume age 100 maturity.
- b) Net single premium (CVAT) and “necessary premium” calculations assume endowment at age 100.
- c) Guideline level premium (GLP) is calculated assuming premiums through age 99.
- d) GLPs accrue through the date between ages 95 and 99, after which the limit applies indefinitely.

Rev. Proc. 2010-28 § 3.02 Safe Harbor Rules (cont.)

- e) 7-pay premiums are computed using remaining durations to age 100.
- f) If 7-pay premiums accrue over fewer than 7 years under (e), accrual ends at age 100, after which the limit applies through the end of the 7-year period.
- g) Reduction-in-benefit rules apply regardless of attaining age 100.
- h) Benefit change after age 100 is not a material change or an adjustment event.

Revenue Procedure 2018-20



Rev. Proc. 2018-20, 2018-11 I.R.B. 427

- Effective February 23, 2018
- “Modifies and supersedes” (replaces) Rev. Proc. 2010-28
- Repeats *Age 100 Safe Harbor Testing Methodologies* from prior Rev. Proc.
- Repeats prior Rev. Proc.’s statement that there is no adverse inference on Section 7702 qualification or MEC status if the safe harbor is not met
- Most significantly, however, ...

Rev. Proc. 2018-20 (cont.)

- The new Rev. Proc. extends the post-age 100 safe harbor rules to “life insurance contracts that:
 - (1) have mortality guarantees based upon prevailing commissioners’ standard tables that extend beyond age 100, such as the 2001 CSO tables and the 2017 CSO tables, and
 - (2) may continue in force after the day on which the insured individual attains age 100.”
- Cites to new Section 7702(f)(10) for definition of prevailing tables
- Presumably precludes need for further guidance on post-age 100 issues under Sections 7702 and 7702A

Product Tax Considerations for the 2017 CSO Mortality Tables



Adoption of the 2017 CSO Tables

Background

- The 2017 CSO mortality tables were approved for use for valuation and nonforfeiture purposes as a result of the adoption of the Valuation Manual (VM), having both a permitted and required date for use as follows:
 - Permitted date: January 1, 2017
 - Required date: January 1, 2020
- The 2017 CSO tables became the prevailing commissioners' standard ordinary table for tax purposes on January 1, 2017:
 - The Section 807(d)(5)(B) transition rule (the operative rule at the time of adoption) for use of a new prevailing table aligns with transition rule provided for in VM, providing for the same "permitted" and "required" dates.
- As noted in the prior slides, the adoption of a new mortality table has implications underlying Section 7702 and 7702A calculations:
 - Definition of "reasonable mortality" is based in part on the prevailing CSO mortality table as defined in new Section 7702(f)(10) and as previously defined in Section 807(d)(5)(A).

Impact of 2017 CSO under Section 7702

- IRS guidance related to the use of the 2017 CSO tables:
 - Notice 2016-63
- Universal life (UL) case study:
 - Impact of 2017 CSO mortality on Section 7702 funding limitations
 - Product tax considerations for UL contracts designed to qualify under guideline premium test (GPT)

IRS Guidance Relating to 2017 CSO

- Notice 2016-63
 - Continuing with its long-standing practice of issuing safe harbor notices to address reasonable mortality requirements related to adoption of new mortality tables, the IRS issued Notice 2016-63:
 - Provides safe harbor rule for use of 2017 CSO mortality tables
 - Provides effective date rules governing contract issue dates
 - Sets forth requirements for continued use of 1980 or 2001 CSO mortality tables following a policy change
- Changes to prior guidance under Notice 2006-95:
 - Extended list of example policy changes that will not affect the determination of the issue date of a contract for purposes of the reasonable mortality charge safe harbors, which now includes:
 - Reduction or deletion of benefits
 - Reinstatements pursuant to applicable state or foreign law

UL Case Study

Overview

- A case study was put together to assess the ability to fund UL contracts under a GPT design, based on 2001 and 2017 CSO mortality guarantees, assuming payment of a GLP.
- Key variables underlying the analysis:
 - Interest crediting rates: Crediting rates today are generally less than the statutory minimum rate of 4% prescribed for the calculation of the GLP, creating an “Interest Rate Shortfall” in the cash value growth needed for contracts to remain in force to their scheduled maturity date.
 - The Interest Rate Shortfall negatively impacts, or impairs, the ability to fund cash values relative to funding based on the prescribed GLP interest rate of 4%.
 - Mortality: Current cost of insurance (COI) charges are generally less than the guaranteed maximum COI charges typically assumed in the calculation of the GLP, with this difference creating a “Mortality Margin.”
 - The Mortality Margin allows for cash values to grow more rapidly based on current COI charges relative to those assuming the higher guaranteed COI charges assumed in the calculation of the GLP.
- Purpose of the analysis: Determine if Mortality Margins are sufficient to offset the Interest Rate Shortfall, such that it would allow contracts to remain in force to their scheduled maturity date.
- Approach: Solve for the interest crediting rate needed for cash values to endow, assuming current COI and expense charges (the “Endowment Interest Rate”).
 - If the Mortality Margin exceeds the Interest Rate Shortfall such that the Endowment Interest Rate is less than the current crediting rate, the contract is projected to remain in force to the scheduled maturity date.

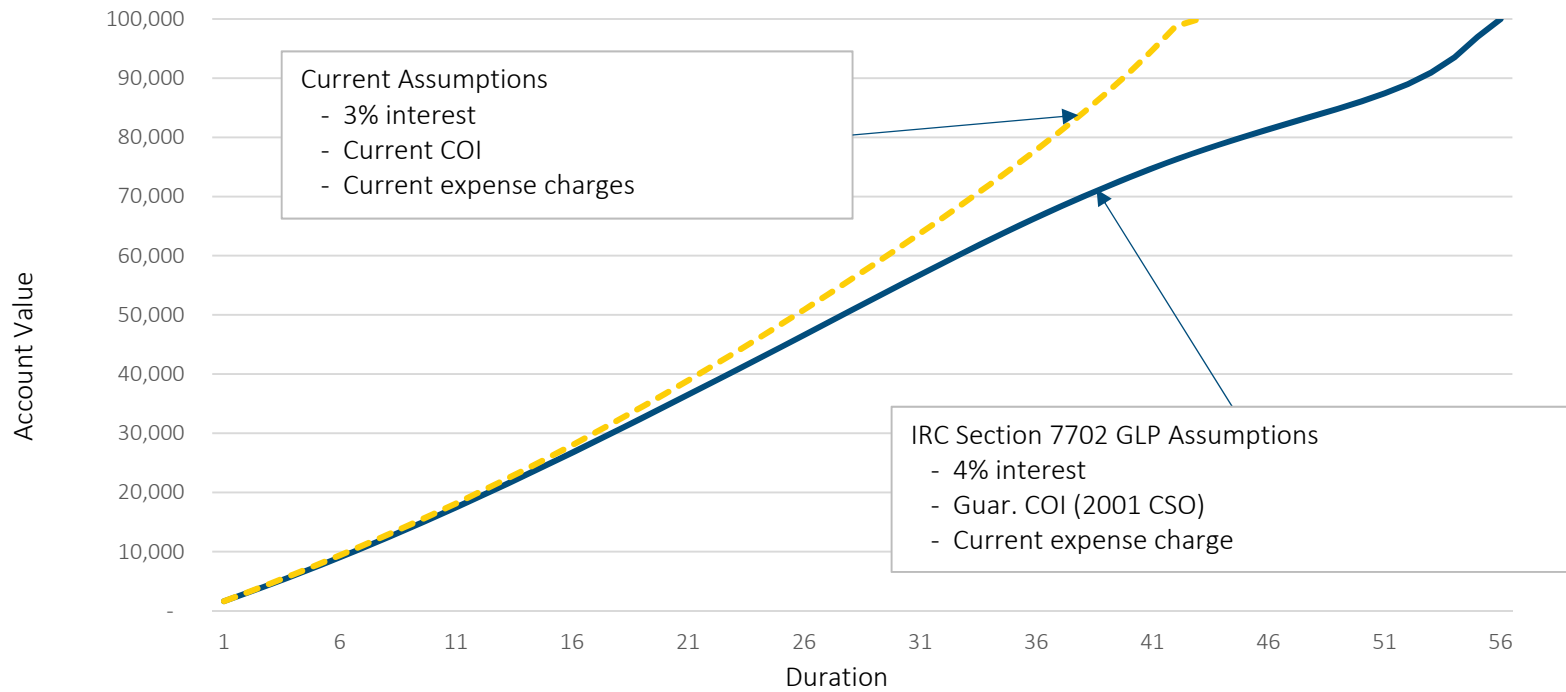
UL Case Study

Test Case Assumptions

- Section 7702 qualification test: GPT
- Funding level: annual premiums equal to the Section 7702 GLP
- Risk class: male, nonsmoker (various issue ages)
- Face amount: \$100,000
- Contract maturity age: 100
- Expenses: 2.5% premium load and \$5 monthly admin. fee (current expenses = guaranteed max. expenses)
- Current COI charges: 2017 CSO “unloaded table” – male, nonsmoker
- Guaranteed maximum COI charges (“loaded table”):
 - Scenario 1: 2001 CSO male, nonsmoker
 - Scenario 2: 2017 CSO male, nonsmoker
- Interest:
 - Current credited interest rate = 3.0%
 - Guaranteed minimum credited interest rate = 3.0%
- No riders or other supplemental benefits

UL Case Study - Scenario 1

Cash Value Projections: GLP (\$1,674) Funding for Male 45 Nonsmoker



UL Case Study - Scenario 1

Endowment Interest Rates

UL Case Study Scenario 1 - Summary Findings 2001 CSO contracts- Male nonsmoker						
Issue Age	GLP	Credited Interest Rate	Endowment Interest Rate	Excess/Shortfall	Interest Rate Shortfall	Mortality Margin
20	619	3.00%	3.21%	-0.21%	-1.00%	0.79%
25	736	3.00%	3.13%	-0.13%	-1.00%	0.87%
30	886	3.00%	3.04%	-0.04%	-1.00%	0.96%
35	1,083	3.00%	2.92%	0.08%	-1.00%	1.08%
40	1,340	3.00%	2.72%	0.28%	-1.00%	1.28%
45	1,675	3.00%	2.45%	0.55%	-1.00%	1.55%
50	2,115	3.00%	2.13%	0.87%	-1.00%	1.87%
55	2,711	3.00%	1.68%	1.32%	-1.00%	2.32%
60	3,512	3.00%	1.12%	1.88%	-1.00%	2.88%
65	4,603	3.00%	0.42%	2.58%	-1.00%	3.58%
70	6,122	3.00%	0.00%	3.00%	-1.00%	>4.00%
75	8,326	3.00%	0.00%	3.00%	-1.00%	>4.00%
80	11,538	3.00%	0.00%	3.00%	-1.00%	>4.00%

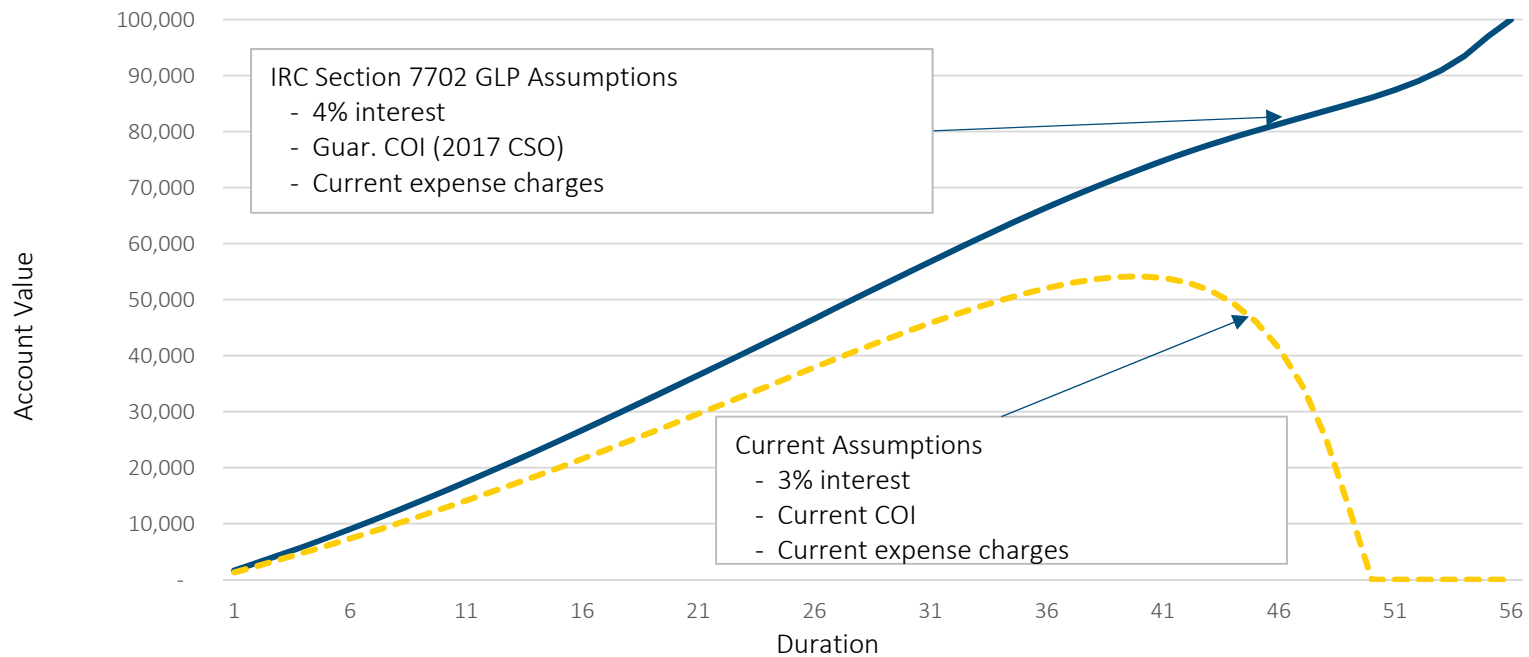
UL Case Study - Scenario 1

Observations

- The Mortality Margin (measured in basis points, or bps) exceeds the Interest Rate Shortfall (100 bps) for most issue ages.
 - Payment of a GLP will generally allow for cash values to endow contracts under current assumptions (e.g., crediting of current interest and assessing current COI and expense charges).
- For certain younger ages, Mortality Margins are generally less than 100 bps, resulting in Endowment Interest Rates that exceed 3.0%.
 - Higher crediting rates are therefore needed for contracts to remain in force to their scheduled maturity date.

UL Case Study - Scenario 2

Cash Value Projections: GLP (\$1,356) Funding for Male 45 Nonsmoker



UL Case Study - Scenario 2

Endowment Interest Rates

UL Case Study Scenario 2 - Summary Findings 2017 CSO contracts- Male nonsmoker						
Issue Age	GLP	Change in GLP from Scenario 1	Endowment Interest Rate	Excess/Shortfall	Interest Rate Shortfall	Mortality Margin
20	523	-15.40%	3.77%	-0.77%	-1.00%	0.23%
25	617	-16.14%	3.76%	-0.76%	-1.00%	0.24%
30	742	-16.25%	3.74%	-0.74%	-1.00%	0.26%
35	904	-16.49%	3.71%	-0.71%	-1.00%	0.29%
40	1,103	-17.67%	3.67%	-0.67%	-1.00%	0.33%
45	1,356	-19.03%	3.62%	-0.62%	-1.00%	0.38%
50	1,691	-20.03%	3.56%	-0.56%	-1.00%	0.44%
55	2,141	-21.03%	3.47%	-0.47%	-1.00%	0.53%
60	2,757	-21.49%	3.33%	-0.33%	-1.00%	0.67%
65	3,627	-21.22%	3.12%	-0.12%	-1.00%	0.88%
70	4,881	-20.27%	2.80%	0.20%	-1.00%	1.20%
75	6,748	-18.95%	2.26%	0.74%	-1.00%	1.74%
80	9,584	-16.93%	1.40%	1.60%	-1.00%	2.60%

UL Case Study - Scenario 2

Mortality Margin Comparison to Scenario 1

UL Case Study Mortality Margins 2001 CSO vs. 2017 CSO - Male nonsmoker						
Issue Age	Credited Interest Rate	Scenario 1 - 2001 CSO		Scenario 2 - 2017 CSO		Difference in Mortality Margin
		Endowment Interest Rate	Mortality Margin	Endowment Interest Rate	Mortality Margin	
20	3.00%	3.21%	0.79%	3.77%	0.23%	0.56%
25	3.00%	3.13%	0.87%	3.76%	0.24%	0.63%
30	3.00%	3.04%	0.96%	3.74%	0.26%	0.70%
35	3.00%	2.92%	1.08%	3.71%	0.29%	0.79%
40	3.00%	2.72%	1.28%	3.67%	0.33%	0.95%
45	3.00%	2.45%	1.55%	3.62%	0.38%	1.17%
50	3.00%	2.13%	1.87%	3.56%	0.44%	1.43%
55	3.00%	1.68%	2.32%	3.47%	0.53%	1.79%
60	3.00%	1.12%	2.88%	3.33%	0.67%	2.21%
65	3.00%	0.42%	3.58%	3.12%	0.88%	2.70%
70	3.00%	0.00%	>4.00%	2.80%	1.20%	-
75	3.00%	0.00%	>4.00%	2.26%	1.74%	-
80	3.00%	0.00%	>4.00%	1.40%	2.60%	-

UL Case Study - Scenario 2

Observations

- GLPs are 15% to 20% lower than those based on 2001 CSO mortality.
- Mortality Margins are lower.
 - Mortality Margins are generally less than 100 bps for most issue ages.
 - Most issue ages require an Endowment Interest Rate of 3.5% or higher.
 - Less investment-driven funding scenarios will require higher Endowment Interest Rates.
- Projected cash values based on current interest and COI assumptions will not endow contracts for most issue ages and funding scenarios without future increases in crediting rates.
- Implications for 2017 CSO UL products that qualify under GPT:
 - Increasing prevalence of no-lapse guarantees
 - Increasing reliance on Section 7702(f)(6) as a way to keep contracts from terminating
 - Continuing trend toward UL products that qualify under Section 7702 using the cash value accumulation test (CVAT)

No-Lapse Guarantees

Section 7702 Considerations

- Effect, if any, under the Section 7702(c)(3)(B)(i) reasonable mortality charge and Section 7702(c)(3)(B)(ii) reasonable expense charge rules:
 - Interest and mortality guarantees relevant to Section 7702 generally those applicable to contract's nonforfeiture cash values
- Interaction with overloan protection riders
- Issues with alternative cash values/benefits and secondary guarantees associated with such values

Section 7702(f)(6)

Administrative Considerations

- The good: Section 7702(f)(6) provides a valuable exception under the GPT that allows for payment of a premium that would otherwise cause a violation of the GPT, provided two conditions are satisfied:
 - The amount of such premium does not exceed the amount necessary to prevent termination of the contract on or before the end of the contract year.
 - The contract will have no cash surrender value at the end of such extension period.
- The bad: The contract holder is essentially left funding the life insurance contract as term insurance.
- The ugly: Challenges in administration of Section 7702(f)(6):
 - Can systems effectively administer Section 7702(f)(6)?
 - Do systems have the ability to administer payments that would otherwise cause premiums paid to exceed the guideline premium limitation?
 - How should the amount of permissible premium under Section 7702(f)(6) be determined?
 - Are systems and/or procedures prone to error?
 - MORE TO COME IN TODAY'S BREAKOUT SESSION!

UL CVAT Design

Product Tax Consideration

- Section 7702 considerations:
 - Contract terms become important as CVAT compliance must be guaranteed “by the terms of the contract”:
 - CVAT is a prospective test that must be met at all times.
 - It must be impossible for the cash surrender value to exceed the net single premium (NSP) under the contract’s mechanics.
 - There is no direct limitation on premiums.
- Section 7702A considerations:
 - Administration of the 7-pay test for CVAT and GPT policies should be largely consistent, with one important exception — ***necessary premium testing (NPT)!***
 - NPT approaches for CVAT policies include:
 - Full NPT system build-out that tests for unnecessary premiums
 - Simplified approach under which material changes are not deferred for contracts in corridor (based on lowest benefits)
 - Other?

Questions?

The Taxation Section Presents

Product Tax Seminar

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Session II: Annuity Product Update

Moderator:

Bryan W. Keene, J.D.

Presenters:

John Glover

Eric G. Lanning

Chris Phanco

Product Tax Seminar

Annuity Product Update – Session II
September 13, 2018

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- **DON'T** discuss your own, your firm's, or others' prices or fees for service, or anything that might affect prices or fees, such as costs, discounts, terms of sale, or profit margins.
- **DON'T** stay at a meeting where any such price talk occurs.
- **DON'T** make public announcements or statements about your own or your firm's prices or fees, or those of competitors, at any SOA meeting or activity.
- **DON'T** talk about what other entities or their members or employees plan to do in particular geographic or product markets or with particular customers.
- **DON'T** speak or act on behalf of the SOA or any of its committees unless specifically authorized to do so.
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Agenda

- IRS / Treasury Agenda
- Escheatment & Annuity Products
- Investment Advisory Fees
- Recently Enacted Legislation
- Legislative Proposals

IRS / Treasury Agenda



Priority Guidance Plan (PGP) – In General

- Concerted effort to list only projects expected to result in guidance in the current plan year
- As a result, a number of items on the PGP in prior years have been removed
- Implications of removal
 - Gone for good or only temporarily?
 - Ability to pursue private letter rulings?

Items on the PGP

- **PBR:** Guidance under IRC §§ 807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principles-based methodologies
- **“Private annuity” rules:** Final regulations on the exchange of property for an annuity contract
- **Missing participants guidance**
- **IRA regulations**
- **Lifetime income:** Guidance on issues relating to lifetime income from retirement plans and IRAs
- **RMD guidance:** Addressing lump sum payments to replace lifetime income under DB plans

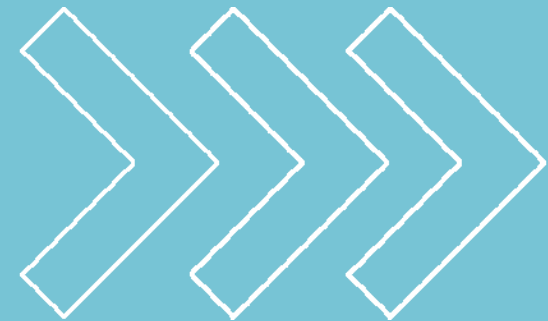
Items Removed

- “Cash surrender value” regulations under IRC §§ 72 and 7702
- LTC Guidance
 - Under IRC §§ 72 and 7702B on annuity contracts with an LTC insurance feature
 - Under IRC § 1035 on exchanges of annuities for LTC insurance contracts
- Captive insurance company guidance
- Section 72(t) penalty tax
- QLAC guidance

Insurance Branch Update

- Personnel
- Published Guidance
- Private Letter Rulings
- Other Activities

Escheatment & Annuity Products



State Law Overview

- Insurers must report abandoned property to the state
 - Personal property is deemed abandoned if no contact with the owner throughout a “dormancy” period
 - Period normally begins when amount is payable
 - E.g., for an IRA, when a distribution was “attempted” or when a tax penalty would arise absent a distribution (RMDs)
 - Dormancy period normally lasts 3 years
- Insurers then must pay the contract value to the state
 - Certain notice requirements for insurer and state
 - State assumes custody of the proceeds

Common Scenarios for Insurers

- Death
 - Plan participant, IRA owner, or non-qualified annuity owner dies
 - Insurer sends a check to the beneficiary of record
 - Check is returned or never cashed
- Lifetime payments
 - Non-qualified deferred annuity reaches its maturity date
 - Required minimum distributions commence pursuant to tax law
 - Insurer sends check to the owner
 - Check is returned or never cashed
- No taxpayer ID number or address for a beneficiary

State Collection Efforts

- States have stepped up efforts to collect in recent years
 - They can use the funds until claimed by the owner
 - They often have retained third party firms to help collect
 - Conduct audits of life insurers (and others)
- Insurers may have withholding obligation to IRS
- States would prefer the gross proceeds
- Catch 22 for the insurer?

Internal Revenue Code

- IRC § 3405 – tax withholding for designated distributions
 - Generally any distribution or payment from or under a qualified plan, IRA, or commercial annuity (including life insurance)
 - Exception if the “individual” elects out, but cannot elect out in the case of any “eligible rollover distribution” from a qualified plan
 - Exception if “reasonable to believe ... not includible in gross income,” but this exception is unavailable for traditional IRAs
- IRC § 6047(d) – tax reporting for designated distributions
 - Apply to any plan or contract from which designated distributions may be made
- IRC § 408(i) – general reporting requirement for IRAs

Rev. Rul. 2018-17

- Facts
 - Individual is a U.S. person and has an “interest” in a *traditional* IRA
 - Individual made no withholding election under IRC § 3405(b)(2)
 - Issuer must pay Individual’s interest to state unclaimed property fund
- Conclusion #1: Withholding required under IRC § 3405
 - The exception for “reasonable to believe is not includible in gross income” does not apply to traditional IRAs (flush language)
 - Thus, the payment is a designated distribution
 - No election out, so 10% withholding applies (nonperiodic distribution)
- Conclusion #2: Reporting required IRC § 408(i)
 - Report on Form 1099-R, showing the Individual as recipient of payment

Rev. Rul. 2018-17 (cont.)

- Roth IRAs not addressed
- SEP IRAs, SIMPLE IRAs & deemed IRAs not addressed
- Ruling does not apply to payments made before the earlier of January 1, 2019, or the date it “becomes reasonably practicable” for the payor to comply earlier

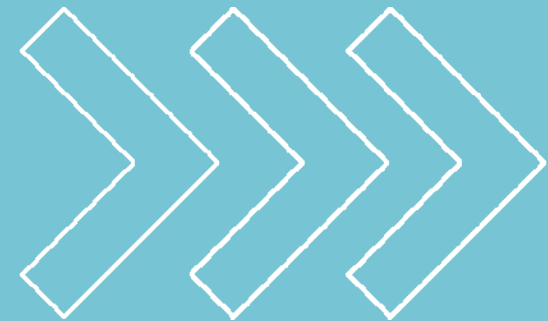
Rev. Rul. 2018-17 (cont.)

- Situations where the flush language does not apply (i.e., amounts are not presumed to be includible in gross income)
 - Roth IRAs
 - Qualified plans and IRC § 403(b) plans
 - DOL: ERISA preempts transfers mandated under state unclaimed property laws
 - DOL has approved sending assets of missing participants to a state in connection with a terminated DC plan
- Implications for non-qualified annuity contracts
 - Similar withholding rules apply (except flush language)
 - Reporting under IRC § 6047(d), not IRC § 408(i)

Missing Participants and Beneficiaries

- IRS, DOL & PBGC are coordinating
- Concerns raised with IRS
 - Withholding and reporting on payments to state unclaimed property funds or bank accounts
 - Search standards
 - Uncashed checks
- Memoranda for Employee Plans (EP) Examinations Employees
 - Directs EP Examiners not to challenge a qualified plan or 403(b) plan for failures to make RMDs to a missing participant or beneficiary
 - Plan must take certain steps to attempt to locate the participant or beneficiary
 - Does not apply to IRAs
- Guidance item on Priority Guidance Plan

Investment Advisory Fees



Investment Advisory Fees

- Background
 - Policyholder of a deferred annuity chooses a third party advisor
 - Advisor provides advice and services relating to the contract
 - A fee is charged against the account value and paid to the advisor
 - Old model, but becoming more common
- Qualified plans, IRC § 403(b) contracts, and IRAs
 - Account / annuity contract was “solely liable” for paying the fee
 - The fee is an expense of the arrangement
 - The assessment of the fee does not constitute a distribution
 - See PLR 9845003 (Aug. 3, 1998), PLR 9047073 (Aug. 30, 1990), PLR 8951910 (Sep. 18, 1989), PLR 9005010 (Nov. 2, 1989)

Investment Advisory Fees (cont.)

- Non-qualified annuity contracts
 - Only one ruling – PLR 9342053 (Jul. 28, 1993)
 - Facts indistinguishable from “qualified” arrangements
 - IRS was adverse
 - The fee is an expense of the policyholder for services the advisor provided to the policyholder
 - The fact that the contract was solely liable for the fee does not “convert” the fee into an expense of contract
 - The policyholder is the only party directly benefiting from the advisor’s services
 - The assessment of the fee constitutes an amount received that is includible in gross income under IRC § 72(e) (income-first rule)
 - Why the different (worse) result?

Recently Enacted Legislation



Tax Cuts & Jobs Act (TCJA) – Roth IRAs

- Recharacterization of Roth IRA conversions
 - **Prior Law:** An individual could recharacterize IRA contributions, including Roth IRA conversions
 - **New Law:** Recharacterizations are not allowed for qualified rollover contributions to a Roth IRA
 - Purpose is to prevent reversing Roth IRA conversions after incurring losses
 - Applies to Roth IRA conversions from qualified plans and traditional IRAs
 - Effective for taxable years beginning after Dec. 31, 2017
(2017 conversion can be recharacterized in 2018)
 - Individuals can still recharacterize regular contributions

TCJA – Qualified Plan Loan Offset Amounts

- A plan loan under IRC § 72(p) generally is offset against the participant's accrued benefit to repay the loan when the plan terminates, the participant terminates employment, or the loan is in default and a distribution event has occurred
- A plan loan offset generally is treated as an actual distribution that can be rolled over within 60 days
- The TCJA extended the rollover period for “qualified plan loan offset amounts”
 - Plan loan offsets due to (1) plan terminations and (2) severance of employment
 - The extended deadline is now the tax return filing deadline, including extensions
- Effective for offsets in taxable years beginning after Dec. 31, 2017

TCJA – Qualified Plan Loan Offset Amounts (cont.)

- Changes to IRS reporting forms
 - Draft 2018 Form 1099-R includes new distribution code “M” in Box 7 for a qualified plan loan offset amount
 - Draft 2018 Form 5498 includes a new code “PO” in Box 13c for a participant who makes a rollover contribution of a qualified plan loan offset amount
 - Added so the IRS can more easily track rollovers of these amounts
- Observations and questions
 - Separate Form 1099-R for other amounts received in a plan termination or severance from employment?
 - Additional intake questions with respect to rollovers into an IRA?
 - If a qualified plan loan offset amount relates to a loan that was previously in default and reported as a deemed distribution, do you report it again if the offset occurs in a later tax year?

TCJA – Wage Withholding

- Wage withholding on periodic payments (IRC § 3405(a)(4))
- **Prior Law:** absent withholding allowance certificate, treat as married claiming 3 withholding exemptions
- **New Law:** “determined under rules prescribed by the Secretary”
- **Notice 2018-14:** For 2018, the rules will “parallel the rules for prior years and be based on treating the payee as a married individual claiming three withholding allowances.”

TCJA – Pass-Through Income

- Qualified Business Income (QBI) deduction under IRC § 199A
 - Deduction is available to “non-corporate” taxpayer, including sole proprietors
 - Up to 20% of QBI
 - Qualified items (essentially, from a US trade or business) of income, gain deduction and loss
 - Qualified trade or business
 - Coincides with reduction in corporate tax rate
- Deduction generally unavailable to:
 - Any “specified service trade or business” (SSTB) and
 - The trade or business of performing services as an employee
- Taxable income exception: deduction fully / partially allowed if:
 - Income is from an SSTB, AND
 - Taxpayer has taxable income below specified thresholds

TCJA – Pass-Through Income (cont.)

- Proposed Regulations clarify SSTB categories
 - *Brokerage services* – does not include services provided by “insurance agents and brokers”
 - *Financial services* – includes managing wealth, advising clients with respect to finances, developing retirement plans, and acting as a client’s agent in the issuance of securities
 - *Investing and investment management services* – receiving fees (commission, flat, or asset-based) for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments

TCJA – Pass-Through Income (cont.)

- Other rules in the Proposed Regulations
 - *Full-time life insurance salesmen* – they are not in the business of being employees merely because they are treated as employees for certain employment tax purposes
 - *De minimis rule* – a trade or business will not be an SSTB merely because it provides a small amount of services in a specified service activity (10% or 5% depending on size)
 - *Crack and pack strategy* – nixed
 - *Effective date* – not effective until final regulations are published, but can rely on the proposed regulations until then

Bipartisan Budget Act of 2018

- Relaxes hardship distribution rules for 401(k) and 403(b) plans
 - **Prior Law:** Elective deferrals (but not earnings thereon) could be withdrawn; must exhaust loans; 6-month prohibition on employee contributions
 - **New Law:**
 - Can withdraw earnings on elective deferrals under 401(k) plans (not 403(b) plans)
 - Need not take all available loans
 - Eliminates 6-month prohibition on contributions
 - Effective for plan years beginning after Dec. 31, 2018
 - Optional or mandatory?

Bipartisan Budget Act of 2018 (cont.)

- Rollover relief for improper IRS levies from plans & IRAs
 - Can be recontributed with interest as a tax-free rollover
 - Without regard to contribution or rollover limits
 - IRS will notify
 - Self-certification is available under Rev. Proc. 2016-47
 - File amended tax return? What about closed years?
- Distribution and loan relief for California wildfire victims

Legislative Proposals



Retirement Enhancement & Savings Act (RESA)

- S. 2526 (Sen. Hatch, R-UT and Chair of SFC)
- Limits “stretches” under IRC § 401(a)(9)
- Annuity safe harbor rules under ERISA
- Relaxes in-service plan withdrawal restrictions for portability of annuities
- Permits post-70½ traditional IRA contributions
- IRC § 403(b) plan terminations

Retirement Plan Simplification & Enhancement Act

- H.R. 4524 (Rep. Neal, D-MA and Ranking Member of W&M)
- Relief from the minimum income threshold test (MITT)
 - Treas. Reg. § 1.401(a)(9)-6, Q&A-14(c)
 - For any annuity with “increasing” payments, the total future expected payments must exceed the amount being annuitized, using certain limiting assumptions
 - The bill would exempt the following from the MITT:
 - Annuity payments that increase by less than 5% per year
 - Commutations determined in good faith using reasonable actuarial methods and assumptions
 - Certain accelerations of payments
 - Payments from participating annuities determined reasonably
 - Return of premium death benefits

RPSEA (cont.)

- Additional MITT relief
 - Test would be deemed satisfied if the initial annuity payment is at least equal to the initial payment that would be required from an individual account
 - Test would be applied using the reasonable “tables or other actuarial assumptions” that the issuer “actually uses in pricing the premiums and benefits,” rather than IRS tables

RPSEA (cont.)

- Qualifying longevity annuity contracts (QLACs)
 - Treas. Reg. § 1.401(a)(9)-6, Q&A-17
 - Repeal the 25% limit on QLAC premiums
 - Increase the dollar limit to \$200,000, indexed
 - Post-issuance divorce will not affect permissibility of purchased QLAC benefits if a QDRO or divorce / separation instrument:
 - Provides that the former spouse is entitled to the survivor benefits,
 - Does not modify the treatment of the former spouse as the contract beneficiary, or
 - Does not modify the treatment of the former spouse as the measuring life for the survivor benefits under the contract
- Many other helpful provisions

Other Legislative Possibilities

- Tax Reform 2.0?
- Technical corrections to Tax Reform 1.0?
- Rothification?
- Retirement Savings Lost and Found Act
 - S. 2474, Sen. Warren, D-MA

Any Questions?





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Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Breakout Session A – ADB and LTC Combination Products

Moderator:

Craig R. Springfield, J.D.

Presenters:

Rebecca Baxter

Lawrence M. Hersh, FSA, MAAA

Samera Kadry

Product Tax Seminar

Breakout Session A

Accelerated Death Benefits and Long-Term Care Combination Products

September 13, 2018



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Product Tax Seminar

Breakout Session A Presenters:

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Pacific Life Insurance Company

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Lincoln Financial Group



Accelerated Death Benefits and Long-Term Care Combination Products



Focus of Session

- Brief Overview of Tax Treatment of Accelerated Death Benefits (ADB) and Long-Term Care (LTC) Combination Products
- Differences Between Qualified Long-Term Care Insurance (QLTCI) Riders and Chronic Illness Riders Addressed By Code § 101(g)
- QLTCI Requirements – Selected Issues to Consider in the Design Process
 - Inflation Protection Requirements
 - Nonforfeiture Benefit Offer Requirement
 - Guaranteed Renewability
- Benefit Triggers, Recertifications, and the Per Diem Limitation
- Adjustments under Code §§ 7702 and 7702A Upon Benefit Payments
- State Specific Considerations, Including in New York and California

Overview of Tax Treatment of ADBs and QLTCI Combination Products

- Code § 7702B – Defines a qualified long-term care insurance (i.e., QLTCI) contract. Enacted by the Health Insurance Portability and Accountability Act of 1996 (HIPAA)
 - *Life-LTC*: Code § 7702B originally authorized only life-LTC combinations. This included riders providing ADBs and riders providing non-acceleration benefits
 - *Annuity-LTC*: Annuity-QLTCI combos authorized by the Pension Protection Act of 2006, effective Jan. 1, 2010 for contracts issued after Dec. 31, 1996
- Code § 101(g) – Applies to ADBs under a life insurance contract paid by reason of chronic illness. Terminal illness ADBs are also addressed.
- Other ADBs (such as for critical illness)

Overview of Tax Treatment of ADBs and LTC Combination Products (cont.)

- Favorable Tax Treatment

- **Code § 7702B QLTCI Benefits** – LTC insurance benefits paid from the QLTCI “portion” of an annuity or life insurance contract generally are treated as excludable accident & health insurance benefits under Code § 104(a)(3)
 - A&H tax treatment extends to LTC benefits the payment of which causes a reduction in the life insurance contract’s death benefit or cash value. See Joint Committee on Taxation’s explanation of the Pension Protection Act, p. 195 (JCX-38-06)
- **Code § 101(g) Benefits** – Chronic illness ADBs from life insurance contracts generally are excludable from income like death benefits
 - The same product may receive favorable tax treatment under both Code §§ 7702B and 101
- **Per Diem Limitation** – Applies to periodic (non-reimbursement) QLTCI benefits and Code § 101(g) chronic illness benefits. For 2018, the limitation generally is \$360 per day (or equivalent, e.g., \$131,400 annually), although it is subject to adjustment by higher costs for qualified LTC services and by reimbursements

Differences Between QLTCI Riders and Chronic Illness Riders Addressed By Code § 101(g)

- Applicable consumer protection rules
 - Jan. 1993 NAIC model rules for QLTCI (Code §§ 7702B(g) and 4980C)
 - Code § 101(g)(3)(B) for Code § 101(g) chronic illness riders
 - Current state law regulation
 - Nonforfeiture offer requirement of Code § 7702B(g)(4)
- “Costs incurred by the payee” requirement of Code § 101(g)
- Business use restriction of Code § 101(g)(5)
- Restrictions on cash value and use of dividends under Code § 7702B(b)(1)(D) and (E)
 - QLTCI with return of premium payable on death or contract cancellation
 - No return of premium exception under Code § 101(g)
- Treatment of charges

QLTCI Consumer Protection Requirements Presenting Design Issues

- **Consumer Protection Requirements Applicable to QLTCI**
 - Jan. 1993 NAIC LTC model rules incorporated as tax requirements
 - Treasury regulations largely defer to state interpretations, but there are important exceptions
- **Inflation Protection**
 - Acceleration riders not subject to requirement
 - But, what about non-acceleration riders?
 - What gets inflated, such as where the non-acceleration coverage depends on the acceleration coverage?
- **Guaranteed Renewability Requirement**
 - Is any concern raised where QLTCI benefits are tied to life insurance benefits which, although typically noncancelable, can change based on various factors (e.g., lack of adequate funding of the life insurance benefit)?

QLTCI Consumer Protection Requirements Presenting Design Issues (cont.)

- Nonforfeiture Benefit Offer Requirement - Code § 7702B(g)(4) requires the offer of inflation protection under any “level premium contract” that must be either reduced paid-up insurance, a shortened benefit period, extended term insurance, or other similar offerings approved by the appropriate State regulatory agency
 - What is a “level premium contract” in this context?
 - What is the role of state interpretations and requirements?
 - When does the nonforfeiture offer requirement apply to an acceleration rider?
 - What is the interaction between the QLTCI rider’s nonforfeiture benefit and the nonforfeiture benefits of the related life insurance contract?
 - What is the scope of “other similar offerings approved by the appropriate state regulatory authority? Are cash benefits encompassed?
 - What amount of nonforfeiture benefit must be provided?

Benefit Triggers and Recertifications

- “Chronically ill individual” – Must have been certified by a licensed health care practitioner within the preceding 12 month period as –
 - being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity, or
 - requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment
- Expectation of permanent condition
- Effective date of certification – How ascertained and relationship to “period” for which the LTC benefit is paid (which is relevant to application of the per diem limitation)
- Recertification timing
 - Gaps in coverage
 - Overlaps in 12-month periods
 - Also relevant to application of the per diem limitation

More on the Per Diem Limitation

- Calculation of Per Diem Limitation
 - Adjustments for higher costs for qualified long-term care services and reimbursements through insurance or otherwise
 - “Period” for calculation
 - Crossing taxable years – benefits for a 12-month period which extends into the next calendar year
 - Tax treatment of benefits in excess of limit
 - Form 1099-LTC reporting
 - Benefit periods – Contractual mechanisms reflective of claims processing
 - Lump sums – Payable due to the insured’s chronic illness
-

Adjustments under Code § 7702 upon Benefit Payments

- **General considerations**
 - Since the statutes' limitations on investment orientation are imposed by reference to benefits and contract funding (whether measured by premiums or cash values), a key question is how these statutes apply when an ADB is paid
 - A contract seemingly should not fail merely due to payment of an ADB, at least where the ADB proportionately reduces death benefits and cash values
- **Cash value accumulation test:**
 - Self-adjusting
 - Lien method (described by § 10A(3) of the NAIC's Accelerated Benefits Model Reg.)

Adjustments under Code § 7702 upon Benefit Payments (cont.)

- Guideline premium test (GPT)
 - Need to adjust both the guideline premium limitation and “premiums paid” which is compared to this limit in a manner that makes sense
 - How does the payment of an ADB affect guideline premiums (or, in other words, what calculation methods are reasonable)?
 - Attained-age decrement method
 - Partial extinguishment approach – If ADBs are viewed as extinguishing part of the life insurance contract, should guideline premiums (GSPs, GLPs, and the sum of GLPs) be proportionally reduced, perhaps based on the percentage reduction in death benefit? See PLR 200651023 and PLR 200652043 (involving divisions of life contracts)
 - Issue-age adjustment or some other methodology?
 - Legislative history silent regarding ADBs
 - Ratcheting abuse not applicable

Adjustments under Code § 7702 upon Benefit Payments (cont.)

- Premiums paid – How does the payment of a chronic illness ADB affect “premiums paid” under Code § 7702(f)(1)? This provision reduces premiums paid by only three amounts:
 - amounts (other than amounts includible in gross income) to which Code § 72(e) applies
 - excess premiums with respect to which there is a distribution described in the recapture rules of Code § 7702(f)(7)(B) or (E)
 - Premiums that are returned with interest within 60 days of the end of a contract year, if the return of such premiums is necessary in order to maintain compliance with the guideline premium test
- Method for reducing “premiums paid” must be consistent with these statutory parameters, but seemingly also should make sense given the method used for adjusting the guideline premium limitation
- The latter two categories arguably may apply to a portion of an ADB if such portion can be characterized as a force-out amount
- Conference Report for HIPAA (H.R. Conf. Rep. 104-736, p. 299) authorized regulations to provide for appropriate reductions in premiums paid

Attained Age Decrement Method – Further Thoughts

- **Effect on Test Limits**

- GPT limits reduce more than dollar-for-dollar
- May require a non-taxable force-out in premiums to keep policy at GPT limit, depending on how “premiums paid” is adjusted

- **Considerations**

- Consistent with other GPT adjustments using the attained age decrement method
- Adjustments to “premiums paid”
 - Is the methodology of the prior slide utilizing the 60-day rule workable?
 - Use of other methodologies?
- Creates possible future funding problems:
 - Lower GPT limit reduces funding available to keep policy from lapsing
 - Guideline premium limitation may decrease
 - Would an additional force-out ever be necessary immediately upon payment of an ADB?
 - What about decrements to GLP on future contract anniversaries?

Partial Extinguishment Method – Further Thoughts

- **Effect on GPT Limits**

- Keeps test ‘in balance’ – both “premiums paid,” the GSP, the GLP, and the sum of GLPs drop by same proportion

- **Considerations**

- Not consistent with the attained age decrement method of Code § 7702(f)(7)(A) and the adjustments to “premiums paid” under Code § 7702(f)(1) that usually accounts for contract changes under the GPT
- Arguably is a reasonable and fair method based on a division of property rationale under which the “accelerated” portion of the contract is treated as extinguished (see PLRs 200651023 and 200652043)
- Avoids reductions in future funding that can occur under attained age decrement method, especially if “premiums paid” cannot be appropriately reduced
- Requires system implementation to reflect different methodology

Adjustments under Code § 7702A upon Benefit Payments

- How should ADBs be accounted for under Code § 7702A, which defines a modified endowment contract(MEC)?
 - Upon an ADB payment which reduces the death benefit, should the reduction in benefits rule of Code § 7702A(c)(2), the material change rule of Code § 7702A(c)(3), or some other methodology apply?
 - Reduction in benefits rule of Code § 7702A(c)(2)?
 - Note that ADBs arguably are “payments” of benefits rather than “reductions” in benefits
 - In all events, it would seem to be improper to re-characterize distributions within the prior two years as having been made under a MEC
 - Material change rule of Code § 7702A(c)(3)?
 - Partial extinguishment approach? Consistency between the approach used Code § 7702 and 7702A, except where statutory differences dictate a different answer?
 - “Amount paid” – Issues are similar to those applicable under the “premiums paid” definition. A different 60-day rule applies under Code § 7702A, in that it generally is based on force-outs required by the 7-pay test
 - Necessary premium test – How should the necessary guideline premium limitation, premiums paid compared against such limitation, the attained age net single premium for lowest benefits, and deemed cash value account for ADBs?

Adjustments under Code § 7702A upon Benefit Payments (cont.)

- Pros and cons of the different methodologies (from a practical perspective)
 - Apply the reduction in benefit rule – This rule is an anti-abuse rule, but there is no abuse here
 - An advantage of this approach for coverage of single lives is that most ADBs occur outside of a 7-pay period, and thus no adjustment is needed, but this will not always be the case (especially for contracts that have frequent material changes)
 - Since systems otherwise apply the reduction rule upon death benefit decreases, this approach usually is the easiest to implement
 - Material change rule – As noted, this approach is supportable based on the view that ADBs are payments, not reductions, in benefits, and this rule arguably applies in that it is the default rule under the statute for accounting for non-reduction changes
 - Partial extinguishment approach, especially if this approach is used for Code § 7702
 - All three of the above methods should be permissible in the absence of guidance, and any guidance should allow flexibility and not require further force-outs merely due to ADBs which proportionately reduce death benefits and cash values
 - If you were at the limit before the ADB, you seemingly should be at the limit after the ADB

State Specific Considerations, Including in New York and California

- New York

- Amendment to § 1113 of the Insurance Law
- NYSDFS Life Bureau Filing Guidance Note (Dec. 20, 2017)
- 11 NYCRR 41.8 – Additional Requirements for Chronic Illness ADBs
 - Tax counsel certification regarding tax treatment of benefits
- Implications for product design and questions about circumstances beyond insurer's knowledge or control
 - Transfer for value and business use situations
 - Per diem limitation and the effect on it from reimbursements of qualified long-term care services (from insurance or otherwise)

State Specific Considerations, Including in New York and California

- **California** – The California Insurance Code section 10295.2(c) provides that:

“An insurer that requires certification that a chronic illness is expected to last longer than 90 days shall include in its filing a legal memorandum from outside tax counsel that the certification would allow for preferable tax treatment under Section 101(g) of the Internal Revenue Code (26 U.S.C. Sec. 101(g)).”
- Role of chronic illness definition in protecting the federal fisc; requirement of recertifications
- Plan of care
- No limit of benefits to per diem limitation
- **Other State Concerns**
 - Line between accelerated death benefits as historically regulated by state laws based on the NAIC’s Accelerated Benefits Model Regulation and LTC insurance (and the state law turbulence that sometimes arises from the different lines drawn between:
 - LTC and non-LTC under NAIC rules and state law, where there usually is no overlap; and
 - Code §§ 101(g) and 7702B under federal tax law, where there is a substantial overlap
 - Period of benefit and lump sum requirements

Questions?



**SOCIETY OF
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The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Breakout Session B – Qualification Errors - What Do I Do?

Moderator:

Brian G. King, FSA, MAAA

Presenters:

Art Dunlavy

Kay Hossofsky

Andy Seydel

Daniela Stoia

Product Tax Seminar

Qualification errors - what do I do?

September 13, 2018



SOCIETY OF ACTUARIES

Antitrust Notice for Meetings

Active participation in the Society of Actuaries is an important aspect of membership. While the positive contributions of professional societies and associations are well-recognized and encouraged, association activities are vulnerable to close antitrust scrutiny. By their very nature, associations bring together industry competitors and other market participants.

The United States antitrust laws aim to protect consumers by preserving the free economy and prohibiting anti-competitive business practices; they promote competition. There are both state and federal antitrust laws, although state antitrust laws closely follow federal law. The Sherman Act is the primary US antitrust law pertaining to association activities. The Sherman Act prohibits every contract, combination or conspiracy that places an unreasonable restraint on trade. There are, however, some activities that are illegal under all circumstances, such as price fixing, market allocation and collusive bidding.

There is no safe harbor under the antitrust law for professional association activities. Therefore, association meeting participants should refrain from discussing any activity that could potentially be construed as having an anti-competitive effect. Discussions relating to product or service pricing, market allocations, membership restrictions, product standardization or other conditions on trade could arguably be perceived as a restraint on trade and may expose the SOA and its members to antitrust enforcement procedures.

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- **Do not** discuss prices for services or products or anything else that might affect prices
- **Do not** discuss what you or other entities plan to do in a particular geographic or product markets or with particular customers
- **Do not** speak on behalf of the SOA or any of its committees unless specifically authorized to do so
- **Do** leave a meeting where any anti-competitive pricing or market allocation discussion occurs
- **Do** alert SOA staff and/or legal counsel to any concerning discussions
- **Do** consult with legal counsel before raising any matter or making a statement that may involve competitively sensitive information

Adherence to these guidelines involves not only avoidance of antitrust violations, but avoidance of behavior which might be so construed. These guidelines only provide an overview of prohibited activities. SOA legal counsel reviews meeting agenda and materials as deemed appropriate, and any discussion that departs from the formal agenda should be scrutinized carefully. Antitrust compliance is everyone's responsibility; however, please seek legal counsel if you have any questions or concerns.

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The views and opinions expressed are solely those of the presenters and not those of the Internal Revenue Service, Ernst & Young LLP or Davis & Harman LLP.

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IRS Office of Chief Counsel

Scenario

In 1997, a new universal life (UL) product was introduced with a guaranteed crediting rate of 3%. It's been recently determined that the Internal Revenue Code (IRC) Section 7702 guideline level premium (GLP) and the Section 7702A 7-pay premium for all policies issued under products developed since 1997 have been computed using a 3% interest rate.

This session will explore the legal, financial reporting and accounting, and operational and actuarial considerations at different points in time as the company navigates its way from discovery of the issue to the eventual remediation of qualification failures with the Internal Revenue Service (IRS) pursuant to Revenue Procedures (Rev. Proc.) 2008-39 and 2008-40. We will assess these considerations across the life cycle of the remediation effort, focusing on the following four phases:

- Discovery phase
 - The period from initial discovery of an error to point where qualification failures can be identified
- Quantification phase
 - The period from the identification of qualification failures to being able to estimate the liabilities (e.g., toll charges) associated with them
- System and policy remediation phase
 - Period where liabilities for the qualification failures are being refined, IRS filing strategies are being finalized and administration system corrections are being implemented, culminating with the filing of closing agreement offers with the IRS
- IRS remediation phase
 - Period between filing closing agreements with the IRS and the eventual execution of the closing agreements

Discovery Phase

Assessment of the error has resulted in the following information:

Number of contracts affected by the error 35,000 (estimated)

Exposure to failed contracts:

Number of failed contracts Unknown
Rev. Proc. 2008-40 toll charge Unknown

Exposure to inadvertent modified endowment contracts (MECs):

Number of inadvertent MECs Unknown
Rev. Proc. 2008-39 toll charge Unknown

Expected external costs:

Professional support fees \$500,000
Administration system support \$500,000

Expected internal costs \$1,000,000

Discovery Phase

Legal considerations

- Legal is proactive: At this point, you only know that there is a legal error that affects 35,000 contracts, but you do not know which contracts actually fail to satisfy the requirements of IRC Section 7702 and/or 7702A due to the error. Thus, you do not have the necessary information to determine for which contracts the company has failed to file returns or has filed incorrect returns.
- Understand the ramifications of what you know and what you do not know.
- Depending on the size and nature of the organization, what framework is best suited to address the compliance issue within the company?
 - A team should be created to address the compliance issue identified and should include representation from each area that will need to be part of the remediation process, e.g., Legal, Actuarial, IT. Should Legal lead the team? Are there other functional areas within the organization that should be included?
 - Create a timeline for addressing the compliance issue with specific goals that must be accomplished by target dates – constantly re-evaluate timeline and adjust as needed to keep the project moving timely while not sacrificing results.
- Consider when a policyholder communication is appropriate.

Discovery Phase

Legal considerations

- Identify avenues for remediation
 - Failed contracts:
 - Rev. Proc. 2008-42-auto waiver (not available for legal and programming errors), IRC Section 7702(f)(8) waiver (last waiver issued in 2009) and Rev. Proc. 2008-40-closing agreement
 - Do you know enough yet about the nature of the error to narrow the avenues for pursuing remediation and investigation?
 - Inadvertent MECs: Rev. Proc. 2008-39
- How do you minimize exposure to the IRS and policyholders?
 - Involve the litigation team that deals with class action lawsuits and state insurance department complaints as early in the process as feasible.
 - Evaluate your exposure and the policyholders' exposure to penalties if the IRS were to identify this issue on audit.
 - Without a precise identification of how many failed contracts there are, only a sense of the exposure can be ascertained, e.g., 35,000 potential failed contracts with the earliest failures probably around the early 2000s, would result in 15 or more years of penalty exposure.
 - Consider issues relating to filing returns or not filing returns (e.g., Form 1099-R) with respect to the contracts when there is uncertainty about whether they meet the requirements of IRC Section 7702 and are not MECs.
 - Put in place a manual overlay to prevent premiums in excess of the IRC Section 7702 and IRC Section 7702A limits from being credited to contracts (such excess premiums could be refunded with interest in accordance with the 60-day rules of IRC Sections 7702(f)(1)(B) and 7702A(e)(1)(B) to maintain compliance).

Discovery Phase

Operational and actuarial considerations

- Determine scope of issue and potential qualification failures
 - Assess which products and/or timeframes are affected by error
 - Develop approach for calculating correct product tax limits
 - Independent compliance testing tool? Illustration system?
 - Assess whether other errors may be present in system or procedures
 - Retest all affected contracts to determine potential qualification errors

Discovery Phase

Operational and actuarial considerations

- Develop approach to stop future occurrences of noncompliance (in consultation with legal department)
 - Modify new business illustration system to properly calculate guideline premium and 7-pay limits, and coordinate rollout to distribution partners.
 - Set up manual procedures to prevent or minimize ongoing exposure to noncompliance
 - Initially identify at-risk contracts (e.g., those with a ratio of premiums to face amount > X%) and flag financial transactions on those contracts for actuarial review
 - Set up team to be responsible for identifying and performing manual calculations for flagged transactions
 - Document procedures for operations area that would allow them to flag risky transactions (e.g., face amount reductions) and subsequent steps, including escalation for actuarial review and communication to policyholders
 - Identify transactions that have risk of noncompliance and flag those transactions for actuarial review
 - Use compliance testing tool to correctly determine guideline premium and 7-pay premium limits for flagged policies
 - Develop procedures to refund excess premium pursuant to the 60-day rule in IRC Sections 7702(f)(1)(B) and 7702A(e)(1)(B) to prevent additional qualification failures prior to fixing administration system
 - Discuss potential internal and external communications to make key stakeholders aware of issue
- Plan for change to administration system to correct error
- Discuss with leadership group how to prioritize these objectives with existing IT and product initiatives

Discovery Phase

Financial reporting and accounting considerations

- Relevant accounting guidance and key differences
 - Accounting Standards Codification (ASC) 740, *Income Taxes*
 - Applicable to income taxes – uncertain tax positions (UTP)
 - Assume the IRS will examine the tax position as of the balance sheet date
 - Two-step process
 - Recognition – if not more likely than not (MLTN) to be sustained, then establish a full UTP liability
 - Measurement – largest amount of benefit that is MLTN (determined by cumulative probability) of being realized upon ultimate settlement with the taxing authority
 - ASC 450, *Contingencies*
 - Applies to loss contingencies (which includes non-income-based taxes)
 - IRS information reporting and withholding penalties, toll charges and operational costs
 - Assess the likelihood of the loss
 - **Probable** – record a loss in the income statement
 - **Reasonably possible** – disclosure only
 - **Remote** – only disclosure if can reasonably estimate and if material
 - Must be able to **reasonably estimate** the amount of the loss
 - Range of loss – if no better point in the range, then record the low end

Discovery Phase

Financial reporting and accounting considerations

- How do you deal with the “exposure period” – the point from discovery of the issue to filing of the closing agreement?
 - Federal income tax considerations (ASC 740)
 - Do you have established tax accounting methods that would now be considered impermissible?
 - Appropriateness of tax reserve methodologies for failed life insurance contracts
 - Specified insurance contract subject to capitalization under IRC Section 848
 - Do you still qualify as a life company under IRC Section 816
 - Do these tax positions meet the MLTN recognition standard?
 - Non-income tax considerations (ASC 450)
 - IRC Sections 6621 and 6622 relating to Information reporting and withholding penalties
 - IRC Section 6651 – Failure to file tax return or pay tax
 - Estimate of closing agreement costs
 - Probable standard is likely met, but do we have enough information to reasonably estimate the loss or range of loss?
 - Other financial statement considerations
 - Form 10K and Form 10Q – when the information is known will be critical in determining the period of accounting
 - Is the filing of an 8K warranted?
- Other questions relating to the potential qualification failures that might lead to different accounting considerations:
 - All US insured or do you have foreign insureds?
 - Does the company plan to remediate all failed policies and inadvertent MECs? And what if they don't?

Status update – 6-month mark

End of Discovery Phase

- A project team consisting of representatives from Legal, Actuarial, Operations and IT has been formed, and a preliminary project plan has been developed to record key tasks and timelines.
- A review of the administration system has confirmed that the interest rate error is the only qualification error.
- Illustration systems have been corrected and disseminated to distribution channels.
- An independent compliance testing tool has been developed to historically apply the guideline and 7-pay test to all affected contracts, resulting in the identification of guideline premium test (GPT) failures and inadvertent failures of the 7-pay test.
 - The interest rate error still exists in the administration system, and contracts are still being administered with incorrect guideline premiums and/or 7-pay premiums.
- Next steps:
 - Calculate toll charge estimates under Rev. Proc. 2008-39 and Rev. Proc. 2008-40.
 - Determine estimate of policy corrections (i.e., refunds of excess premiums or addition of death benefit) required to bring contracts into compliance with the GPT and 7-pay test.
 - Implement procedures to prevent future qualification failures.

Quantification Phase

Assessment of the error has resulted in the following information:

Number of contracts affected by the error	40,000
Exposure to failed contracts:	
Number of failed contracts	4,000
Rev. Proc. 2008-40 toll charge	Unknown
Exposure to inadvertent MECs:	
Number of inadvertent MECs	7,000
Rev. Proc. 2008-39 toll charge	Unknown
Expected remaining external costs	
Professional support fees	\$500,000
Administration system support	\$750,000
Expected remaining internal costs	\$1,000,000

Quantification Phase

Legal considerations

- Legal is reactive to quantification results, but could be proactive if toll charge exposure is great.
- Is the toll charge identified the most cost-effective toll charge that the IRS permits to be paid?
 - If the toll charge is high (e.g., \$1 million), consider with Actuarial whether any of the assumptions used could be altered in a manner permitted by the IRS to reduce the toll charge.
- Once the company has determined which contracts are noncompliant, the dates of the contracts' noncompliance and the toll charges to be paid to correct the contracts under closing agreements with the IRS, the company will be able to:
 - Ascertain, generally, the exposure to policyholders and the IRS.
 - Determine which remediation avenue to pursue depending on the toll charge exposure and facts (e.g., if the toll charge to obtain closing agreements to correct the IRC Sections 7702 and 7702A compliance failures is \$50,000, it would not make sense to pursue any other avenue).
- *Start to consider* whether you will refund amounts or increase the death benefits to bring the contracts back into compliance, i.e., identify the path of least resistance for taking corrective action (e.g., refunds) and what legal issues that path raises (e.g., tax reporting considerations).
- If the company has not made a final decision of whether to engage outside counsel to prepare the IRS submissions, that decision should be made no later than the Quantification Phase (that enables outside counsel to advise, for example, on the assumptions that should be used for the toll charge calculation).

Quantification Phase

Operational and actuarial considerations

- Develop a tool to calculate Rev. Proc. 2008-39 and Rev. Proc. 2008-40 potential toll charges and policy correction amounts
 - Present preliminary findings for discussion with leadership group
 - Determine whether any assumptions or calculations to determine qualification failures should be adjusted – consult with internal and external legal and actuarial resources as needed to determine risk and reward
 - Review potential IRS filing strategies and how they may impact company from financial and risk perspectives (e.g., cost and/or risk of delaying filing until after all system corrections are complete, file one closing agreement request while delaying the filing of the other closing agreement requests)
 - Review and validate results
 - Estimate potential fees for any external costs
 - Estimate projected growth in toll charges between initial quantification of liabilities and actual date of filing of agreement with IRS (i.e., “burn rate”)
- Begin planning for policy and system remediation

Quantification Phase

Financial reporting and accounting considerations

- Considerations given the following:
 - Expected internal and external costs are available.
 - Number of failed contracts and inadvertent MECs are known.
 - Toll charge estimates are still unavailable.
- Federal income tax accounting considerations
 - Assuming UTP liabilities were established:
 - Adjust the UTP liability for tax positions specific to only the known failed contracts
 - Consider the impact of open vs. closed tax years on income tax returns
 - Update penalties and interest related to UTP liability
- Non-income tax accounting considerations
 - Mostly likely not able to reasonably estimate exact liability
 - Ability to refine range of loss contingency estimates

Status update – 12-month mark

End of Quantification Phase

- Updates have been made to the number of qualification failures.
- Rev. Proc. 2008-39 and Rev. Proc. 2008-40 toll charges have been estimated.
- Cost of policy corrections has been estimated for both refunding excess premium (and earnings) and increasing death benefits.
- Next steps
 - Fix the interest rate error in the administration system and/or inforce illustration systems.
 - Update incorrect guideline premiums and 7-pay premiums in administration system.
 - Determine form of policy corrections (i.e., refunds of excess premium vs. death benefit increases) to be implemented upon execution of the closing agreements by the IRS.
 - Prepare for filing IRS closing agreements.

System and Policy Remediation Phase

Assessment of the error has resulted in the following information:

Number of contracts affected by the error	45,000
Exposure to failed contracts:	
Number of failed contracts	4,300
Rev. Proc. 2008-40 toll charge	\$500,000
Amount of excess premium refunds	\$350,000
Cost of providing additional death benefit	\$500,000
Exposure to inadvertent MECs:	
Number of inadvertent MECs	7,200
Rev. Proc. 2008-39 toll charge	\$1,500,000
Amount of excess premium refunds	\$150,000
Cost of providing additional death benefit	\$75,000
Expected remaining external costs	
Professional support fees	\$250,000
Administration system support	\$750,000
Expected remaining internal costs	\$700,000

System and Policy Remediation Phase

Legal considerations

- Controls preparation of IRS submissions
- Select avenue to correct the failed contracts (Rev. Proc. 2008-40) and inadvertent MECs (Rev. Proc. 2008-39)
 - Work with Actuarial to prepare IRS submissions
 - Actuarial will provide information on the cause of the error, the corrective action implemented to prevent its recurrence (e.g., modification of the administration system to calculate correct limits under IRC Sections 7702 and 7702A), the toll charges due under the Rev. Proc. 2008-40 and Rev. Proc. 2008-39 closing agreements, etc.

System and Policy Remediation Phase

Legal considerations

- Finalize decision on how to bring contracts back into compliance with IRC Sections 7702 and 7702A pursuant to the closing agreements:
 - Which contracts will require corrective action under the terms of the closing agreements depends on a number of unknown and evolving factors such as when the IRS will execute the closing agreements, the status of the contracts at that time (e.g., in force or terminated), the funding of the contracts at that time (e.g., are the premiums paid/amounts paid no more than would be permitted under the IRC Sections 7702 and 7702A limits?). In many closing agreements, few contracts actually require corrective action.
 - Most companies refund excess premiums with interest to bring contracts back into compliance:
 - Reflecting the assumption that contracts with excess premiums will continue to require corrective action when the IRS executes the closing agreements, consider whether there are any unique issues that need to be addressed (e.g., insufficient cash values to support refunds due to outstanding loans).
 - If the terms of the contracts do not readily allow for refunds, then increase the contracts' death benefits. In such cases, consider:
 - How the death benefit increase will be effectuated under the terms of a contract (i.e., would it be possible to increase the contracts' death benefit and if it is not, could a term rider on the primary insured to age 95 be added to the contract?)
 - What policyholder communication and/or additional actions (e.g., the company paying any additional cost of insurance charges) will minimize policyholder complaints about the death benefit increases?
 - The legal issues under Rev. Proc. 2008-39 relating to death benefit increases and how such increases will be effectuated to address those issues (e.g., what is the amount of the death benefit increase needed? When does it become effective for purposes of calculating 7-pay premiums and the payment of benefits on the death of insured? How long does the death benefit increase last?)

System and Policy Remediation Phase

Operational and actuarial considerations

- Coordinate IRS filings with implementation of administration system corrections and/or temporary manual procedures to ensure error(s) do not reoccur
- IRS remediation
 - Calculate and validate final toll charges for closing agreement with updated policy data
 - Determine methodology for implementing policy corrections upon execution of IRS closing agreements
 - 90 days to make corrections after IRS executes
 - Review characteristics of policies requiring corrective action (e.g., policies requiring correction under both closing agreements)
 - If death benefit increase is considered for correction, is a contract endorsement needed?
- System and procedures remediation
 - Finalize plan for system changes and corrections to be implemented prior to IRS filing
 - Finalize and document procedures to be implemented (both temporary and permanent)
 - Finalize coordination of system corrections with other IT initiatives, determine time frame for implementation
 - Engage outside assistance as needed
 - Implement plan to correct system errors and/or for manual procedures

System and Policy Remediation Phase

Financial reporting and accounting considerations

- Considerations given the following:
 - Expected internal and external costs are available.
 - Number of failed contracts and inadvertent MECs are known.
 - Toll charge estimates have been determined.
 - Estimate of the cost for providing additional death benefit is available.
 - Estimate of the amount of refunds of excess premium (and earnings) is available.
- Federal income tax accounting considerations
 - If UTP liabilities were established, has passage of time impacted the liability?
 - Consider the impact of open vs. closed tax years on income tax returns
 - Update penalties and interest related to UTP liability
- Non-income tax accounting considerations
 - Are we now able to reasonably estimate a loss, or is our estimate still a range?
 - Update accrual amounts and disclosures if necessary

Status update – 18-month mark

End of System and Policy Remediation Phase

- Updates have been made to the number of qualification failures and toll charges.
- Policy corrections will be in the form of a refund of excess premiums (and earnings).
- Interest rate error has been fixed, and correct GLPs and 7-pay premiums are being used in the ongoing administration of contracts.
- Closing agreement requests have been filed with the IRS.
- Next steps:
 - Prepare for actions needed upon execution of the closing agreement.

IRS Remediation Phase

Assessment of the error has resulted in the following information:

Number of contracts affected by the error	48,000
Exposure to failed contracts	
Number of failed contracts	4,400
Rev. Proc. 2008-40 toll charge	\$575,000
Exposure to inadvertent MECs	
Number of inadvertent MECs	7,300
Rev. Proc. 2008-39 toll charge	\$1,600,000
Expected remaining external costs	
Professional support fees	\$100,000
Administration system support	\$50,000
Expected remaining internal costs	\$100,000

IRS Remediation Phase

Legal considerations

- Respond as necessary to any IRS questions about the submission
- When the IRS executes the closing agreements:
 - Be prepared to quickly refresh your data and identify which contracts require refunds under the Rev. Proc. 2008-40 and Rev. Proc. 2008-39 closing agreements
 - Be prepared to refund excess premiums with interest under the Rev. Proc. 2008-40 closing agreement (or excess premiums with earnings thereon under the Rev. Proc. 2008-39 closing agreement) within 90 calendar days
 - Be prepared to pay the toll charges to the IRS within 60 calendar days
 - Have established contingency plans to make sure these deadlines are met
 - Have considered the tax reporting required with respect to the refunds
 - What is reported on Form 1099-R?
 - What is reported on Form 1099-INT?
 - Refunds required under both the Rev. Proc. 2008-39 and the Rev. Proc. 2008-40 closing agreements
 - Have drafted any necessary policyholder communications, e.g., letters accompanying refunds and Q&As to be used if policyholders have questions about the refunds

IRS Remediation Phase

Operational and actuarial considerations

- Prepare for administration of the premium refunds
 - Impact of refund on IRC Section 7702 premiums paid, IRC Section 7702A amounts paid and cost basis
 - Considerations for premium refunds under Rev. Proc. 2008-40 on contracts that are MECs
 - Considerations for contracts requiring a refund of both excess guideline premium and excess 7-pay premium
- Plan for policyholder and agent communications for contracts needing a correction to maintain compliance
 - Explanation of correction
 - Tax consequences of the refund (including accumulated earnings on the excess premium)
- Customer service training to answer questions from policyholders and agents

IRS Remediation Phase

Financial reporting and accounting considerations

- Considerations given the following:
 - Expected internal and external costs are available.
 - Number of failed contracts and inadvertent MECs are known.
 - Closing agreements have been filed.
- Federal income tax accounting considerations
 - Can UTP liabilities should be removed?
 - Does filing of closing agreement meet the effectively settled standard?
- Non-income tax accounting considerations
 - Update accrual amounts and disclosures if necessary.
 - Consider amounts already paid.

Status update – 24-month mark

End of IRS Remediation Phase

- IRS has executed the Rev. Proc. 2008-39 and 2008-40 closing agreements.
- Refunds of excess premiums and earnings have been issued within 90 days of the execution date of the closing agreements.
- Elapsed travel time across all 4 phases: 24 months
- Total costs incurred:
 - Toll charges \$2,175,000
 - Internal costs \$2,000,000
 - External professional fees (legal and actuarial) \$1,500,000
 - External administration system support \$1,000,000
- Company has decided to implement a Product Tax Compliance Working Group to proactively mitigate product tax compliance risk on an ongoing basis.
 - More to come on this during tomorrow's general session on managing product tax risk

Questions?



The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Breakout Session C – Grandfathering Considerations for Life Insurance and Annuities

Moderator:

Sheryl Flum

Presenters:

Steve Feldman

Mandana Parsazad

Dan Phillips

2018 Product Tax Seminar

Grandfathering Considerations for Life Insurance and Annuities Breakout Session C

September 13, 2018



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- **DON'T** discuss your own, your firm's, or others' prices or fees for service, or anything that might affect prices or fees, such as costs, discounts, terms of sale, or profit margins.
- **DON'T** stay at a meeting where any such price talk occurs.
- **DON'T** make public announcements or statements about your own or your firm's prices or fees, or those of competitors, at any SOA meeting or activity.
- **DON'T** talk about what other entities or their members or employees plan to do in particular geographic or product markets or with particular customers.
- **DON'T** speak or act on behalf of the SOA or any of its committees unless specifically authorized to do so.
- **DO** alert SOA staff or legal counsel about any concerns regarding proposed statements to be made by the association on behalf of a committee or section.
- **DO** consult with your own legal counsel or the SOA before raising any matter or making any statement that you think may involve competitively sensitive information.
- **DO** be alert to improper activities, and don't participate if you think something is improper.

- If you have specific questions, seek guidance from your own legal counsel or from the SOA's Executive Director or legal counsel.

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Agenda



Overview of sections 7702 and 7702A



What is a “material change”?



IRS Notice 2016-63

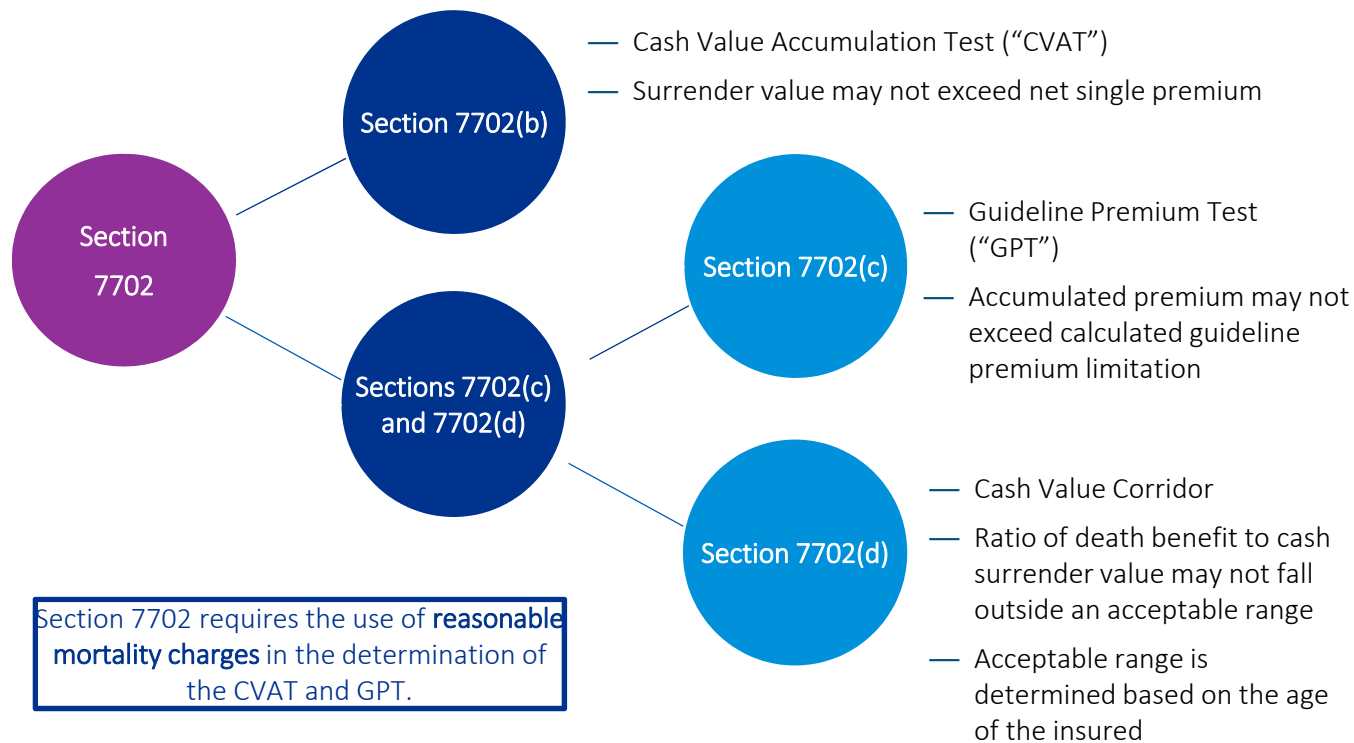


Grandfathering considerations



Questions

Section 7702: Life insurance contract defined



Section 7702A: Modified endowment contract (“MEC”) defined

- Any contract meeting the requirements of 7702 which:
 - a. is entered into on or after June 21, 1988, and
 - b. fails to meet the 7-pay test of section 7702A(b)
- 7-pay test
 - A contract fails to meet the 7-pay test of this subsection if the accumulated amount paid under the contract at any time during the first 7 contract years exceeds the sum of the net level premiums which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums.
 - Retrospective test, requires ongoing monitoring of contract activity
 - Developed to discourage the marketing of single premium life insurance contracts solely for investment purposes
- A MEC can also be a contract that meets the requirements of 7702 that is received in exchange for a MEC.

Definition of “material change”

- Contracts received in exchange for existing contracts are generally considered to be new contracts **issued on the date of the exchange**.
 - A change to an existing contract is not considered to result in an exchange if the terms of the resulting contract are the same as the terms of the contract prior to the change.
 - “Terms” include:
 - Amount and pattern of death benefit
 - Premium payment pattern
 - Rate(s) guaranteed on issuance of the contract
 - Mortality and expense charges
- Section 7702A(c)(3)
- Section 7702(f)(7)
 - If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under section 7702.
- If a material change is deemed to occur, re-testing of a contract (possibly with a different mortality table) may be necessary to qualify it anew under sections 7702 or 7702A.

Consequences of Material Change

- May create new “issue date”
- Issue date determines applicable rules
 - 7702 may apply to contract originally issued before effective date of those requirements
 - new mortality table may apply
- May result in contract failing to qualify as life insurance for tax purposes

Guidance Concerning Use of 2017 CSO Mortality Tables

- Effective October 19, 2016
- Provides safe harbor guidance for use of the 2017 CSO mortality tables in calculations under sections 7702 and 7702A to interpret the “reasonable mortality charge” requirement of section 7702(c)(3)(B)(i)
- Maintained all safe harbors from previous guidance (Notice 2006-95)
- One significant departure from previous guidance
 - If the only change to an existing contract is a reduction or elimination of benefits provided under the contract, that change will not affect the determination of the issue date of a contract for purposes of the reasonable mortality charge safe harbor.
 - Result: A mere reduction of death benefits – even if the contract does not specifically allow a policyholder to unilaterally request such a reduction – will not result in a material change.
 - Industry advocated for this revised IRS position

When is a contract grandfathered?

- Notice 2016-63, Section 5.02
 - If the mortality charge with respect to a life insurance contract did not exceed 100% of the applicable mortality charge set forth in the applicable mortality table **at the time of the contract's issuance**, then re-testing of a contract under the new 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 new tables for that contract under its standard valuation and minimum nonforfeiture laws; and
 3. The contract continues upon the same policy form or blank
 - “Change, modification, or exercise of a right to modify or add benefits” includes:
 - Addition or removal of a rider or a qualified additional benefit
 - Increase or decrease in death benefit, or change in death benefit option
 - Reinstatement of a policy of a policy within 90 days after its lapse (or as required under applicable state or foreign law)
 - Reconsideration of ratings based on rated condition, lifestyle, or activity
- Additional analysis may be required to determine whether each individual contract is grandfathered.



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The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Breakout Session D – Life Insurance Force-outs and Section 7702(f)(6) Considerations

Moderator:

John T. Adney, J.D.

Presenters:

Lawrence M. Hersh, FSA, MAAA

Craig R. Springfield, J.D.

Product Tax Seminar

Breakout Session D

Life Insurance Force-outs and
Section 7702(f)(6)
Considerations

September 13, 2018



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Product Tax Seminar

Breakout Session D Presenters:

John T. Adney, Esq., *Moderator*
Davis & Harman LLP

Larry Hersh, FSA
Pacific Life

Craig R. Springfield, Esq.
Davis & Harman LLP



Life Insurance Force-outs and Section 7702(f)(6) Considerations - Introduction



Focus of Session

- Management of inforce universal life insurance policies qualifying under the section 7702 guideline premium test (GPT), including:
 - consideration of administration systems design
 - policy owner communications
- Drawing heavily from Larry Hersh's article, "Guideline Policy Forceouts – Effects on Policy Values and Administration of Universal Life Policies," *Taxing Times*, Vol. 14, Issue 1, p. 14 (Feb. 2018)
- Questions and comments are welcome

Circumstances for Consideration

- GPT policy issued assuming higher than current interest rates
- Low interest rate environment of recent decade
- Policy well funded according to original plan but now in later durations
 - Policy owner seeks to take a partial withdrawal
 - Policy owner seeks to reduce death benefit to avoid need for additional premiums
- Alternative to consider: chronically underfunded policy

Statutes to Consider

- Section 7702(f)(7)(A) – adjustment of guideline premiums
- Section 7702(f)(7)(B)-(E) – recapture ceiling rules
- Section 7702(f)(6) – premiums allowed beyond guideline premium limitation
- Section 7702A(c)(2)(A) – reduction in benefits (MEC rules)

Statutes to Consider (cont.)

- Section 7702(f)(7)(A) – adjustment of guideline premiums

“If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under [section 7702].”

- Known as attained age adjustment rule
- Adds attained age-based guideline premiums at time policy benefits increase, subtracts them at time benefits decrease
- Disregards sufficiency (or not) of current funding of policy

Statutes to Consider (cont.)

- Section 7702(f)(7)(B)-(E) – recapture ceiling rules
- Somewhat complex set of rules applicable in policy's first 15 years
- Imposes limited version of gain-out-first treatment of cash distributions made in connection with or anticipation of benefit reductions
- Differs between cash value accumulation test policies and GPT policies
- Differs between benefit decreases in first 5 years and later decreases
- Largely replaced by section 7702A (MEC) rules, but still applicable such as in case of section 1035 exchange

Statutes to Consider (cont.)

- Section 7702(f)(6) – premiums allowed beyond guideline premium limitation (by not counting as “premiums paid” under section 7702(f)(1) if certain conditions are met):

“The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of [the GPT limitation] if the amount of such premium does not exceed the amount necessary to *prevent the termination of the contract* on or before the end of the contract year (but only if the contract will have *no cash surrender value* at the end of such extension period).”

Statutes to Consider (cont.)

- Section 7702A(c)(2)(A) – reduction in benefits (MEC rules)

“If there is a reduction in benefits under the contract within the 1st 7 contract years, [section 7702A] shall be applied as if the contract had originally been issued at the reduced benefit level.”

- Rule applies in 7 years after policy issuance as well as 7 years after policy exchange
- Companion rule for joint-and-survivor policies, section 7702A(c)(6), applies to a death benefit reduction at any time
- Application of either rule tends to create a MEC

Application of Rules and Related Considerations



Product Tax Administration Guideline Forceouts

Discussion Topics for Today:

- How a Guideline Forceout can occur
- What are the effects on Policy Values
- Guideline Premium Solves
- Section 7702(f)(6) Premium Exception
- Effects on Policy Administration

Guideline Premium Forceout

- As cited before, if Benefits are adjusted, section 7702(f)(7)(A) requires a redetermination of Guideline Premiums
- For reductions in benefits, this is done using the Attained Age Decrement Method, sometimes referred to as “A+B-C” where:
 - A = their current guideline premium as of issue/last adjustment
 - B = the premium calculated today using the ‘new’ benefits
 - C = the premium calculated as of today using the ‘old’ benefits
 - (B-C) notionally is the attained age cost of the difference in benefits

Guideline Premium Forceout (cont.)

What is the result of the “A+B-C” method?

“What goes Up Must Come Down”

- If benefits increase, it allows increased funding reflecting the insured’s increase in age (i.e., attained age) and cost to the consumer
- If benefits decrease: The guidelines may drop either immediately (if GSP) or over time (if GLP)

If GPT Limit drops below the Sum of Premiums Paid (SOPP), then a Forceout withdrawal of cash value is required

Policy Effects of GPT Forceouts

- Cause: Forceouts can be from Face Reductions, Withdrawals, or a Combination of transactions
- Timing: Benefits reduce now, but forceouts often occur later
- Irreversible: If take reduction now, may not qualify for a benefit increase later to offset required forceouts (and may be very expensive)
- Possible taxation: Forceouts are withdrawals, and would be taxable if the policy were a MEC, or if policyowner previously removed cost basis
- Loss of benefits: Forceouts can cause policies to lapse

Guideline Forceout Example: “Mrs. Olsen”

At Policy Issue

- Face Amount = \$750,000, Age 45 at issue
- Paid \$10,000/year for 15 years to age 60
- Had initial GPT Limits of \$150,000 (GSP) and \$15,000 (GLP).
- Extended payments another 5 years to age 65; \$200,000 total premiums

30 Years Later: Options to help with low interest rates

1. Reduce Benefits 50% to \$375,000. Forceouts begin age 90, with illustrated lapse age 92
2. Reduce benefits to \$465,000 to avoid forceouts, but at extra cost
3. Reduce face to \$350,000. Forceouts will return all cost basis (also with illustrated lapse)

Guideline Premium Solves

General idea:

- The “A” and “C” premiums are fixed and determinable
- The “B” premium depends on the benefits
- It is possible to solve for the benefits to achieve a specified Guideline Target such as Forceout all Premiums to Cost Basis

Information that can be provided:

- Planning: In Mrs. Olsen’s case, \$350,000 is the Forceout to Cost Basis as an alternative
- Timing: Can be used at different policy “Stages” (Premiums, Holding, Distributions, Maturity)
- Guardrails on illustrated or other calculated values

Section 7702(f)(6) – How Useful Is It?

- If a policy becomes underfunded such as due to force-outs, section 7702(f)(6) may offer a solution if its requirements are met
 - Rule applies only to the extent premiums cannot be accepted otherwise under the guideline premium test
 - Two requirements must be met:
 - The disregarded premium cannot “exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year”
 - the contract must “have no cash surrender value at the end of such extension period” (including cash value that serves as collateral for a policy loan)
 - If fail to meet either requirement, the premium counts as premiums paid under section 7702(f)(1) and the contract may fail
 - What if there are force-outs too?

Effects on Policy Administration

- Contracts:
 - Review contract provisions regarding Reductions, Forceout distributions
- Systems:
 - Building solves requires system support and testing
 - Can the system accurately identify a future forceout event?
- Illustrations are not the answer
 - May not show the event (e.g., if the policy lapses before forceouts)
 - Coordinate with administrative practices and contract provisions
 - Must train the producers on tax

Policyowner Communication

What is the company's responsibility here?

Considerations:

- Prior communications – Is this “new information”?
- Timing – Communicate now or later?
- What information to provide – Will they understand what you send?
 - Do you provide current or projected limits?
 - Do you provide alternatives?
 - What if there is nothing they can do (e.g., a withdrawal triggers F/O)?



**SOCIETY OF
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The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Session IV: Managing Product Tax Compliance Risk

Moderator:

Philip Ferrari, ASA, MAAA

Presenters:

Robert A. Fishbein, J.D., LL.M.

Kimberly W. Lunn, J.D., LL.M.

2018 Product Tax Seminar

Phil Ferrari, Ernst & Young LLP
Robert Fishbein, Prudential Financial
Kim Lunn, Northwestern Mutual

*Managing Product Tax
Compliance Operational Risk*

September 14, 2018



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Instructors

- Phil Ferrari (Moderator)
 - Ernst & Young LLP
- Robert Fishbein
 - Prudential Financial
- Kim Lunn
 - Northwestern Mutual



Overview

- Product tax compliance and operational risk
 - Summary of the issues
 - Impacts to the product life cycle
 - What is a “Product Tax Compliance Program”?
- Practical application
 - Lessons learned
 - Sample solutions
- Open discussion

Product tax compliance and operational risk



The state of the union ...

Significant regulatory and operational change

- Tax reform and regulatory change, i.e., Tax Cuts and Jobs Act (TCJA)
 - Deferred Acquisition Cost (DAC) tax changes under IRC section 848
 - Tax reserve method and calculations
 - Modifications to the Dividends Received Deduction (DRD)
 - Reporting requirements and changes for life settlement contracts
- New mortality tables and implications on product development
 - Implementation of different products, different timing
 - Transition implications between approaching 1/1/2020 deadline
 - Interpretation and application of the law
- Operational change in the form of business-process outsourcing, policy administration conversion or implementation, as well as hiring, retaining, and training resources

Real-time polling question – How many were in the session "Qualification Errors – What do I do?"

- Many companies ask how did we get here? How do we not get here again?
- The answer may be by ...

Managing Product Tax Compliance Operational Risk ...

Product Tax Compliance (PTC)

Summary of the issues

- Integrated, effective risk management is increasingly more critical to the health and success of insurers, particularly with concerns that regulators may adopt similar standards (e.g., "enhanced prudential standards") imposed by the Federal Reserve on larger insurance companies (e.g., SIFIs and SHLCs).
- PTC risk is becoming a more prevalent consideration.
- Technical – Qualification and testing considerations
 - Scoping for PTC risk
 - Federal vs. state requirements
 - Qualified vs. non-qualified plan requirements
 - Requirements by product, e.g., annuities, life insurance, long-term care, variable
 - E.g., with respect to life insurance, risk of non-compliance with the qualification requirements of IRC Sections 817(h), 7702 and 7702A, and tax reporting requirements of Section 72
- Operational – The most common "gaps" observed
 - Lack of oversight/ownership of product tax compliance
 - Lack of cross-functional communication and cooperation
 - Lack of formalized procedures/controls
 - Lack of documentation and institutional knowledge around products/ systems, interpretations/methods, and general PTC awareness

Potential consequences?

Non-compliance poses a substantial risk to life insurance companies:

- Reputational impact and brand damage
- Policyholder dissatisfaction and lawsuits
- Strained agent relations
- Exposure to information reporting and withholding penalties
- Substantial costs of remediation (contract and system)
- Inquiries from regulators and audit disclosure

Insurance product impacts

Business life cycle and company resources

- Business life cycle impacts, the entire continuum, "front-end" to "back-end"
 - Product development
 - New business/policy issuance
 - Administration
 - Payments/distributions
 - Tax reporting
- Impacts on company resources, particularly product tax attorneys and tax actuaries when new regulation or guidance on existing regulation is released

Product tax compliance program

Formalizing a "program"

- Should companies consider designing and implementing a formal "Product Tax Compliance Program" with a "Product Tax Operating Model" as the foundation?
- Summarizing what we have heard so far ...
 - The Internal Revenue Code (IRC) imposes different qualification and reporting requirements across different products sold by life insurance companies.
 - Product Tax Compliance touches many components and functional areas of the business cycle.
 - The consequences for non-compliance can be significant.
 - Insurance companies either are choosing to (e.g., general broadening of their Enterprise Risk Management programs) or feel compelled to due to regulatory pressure (e.g., "enhanced prudential standards," SIFI/SLHC designations) move toward an enterprise-wide, formalized compliance program.
 - Deciding if PTC presents a material risk and making product tax compliance efforts manageable, sustainable, and auditable

Product tax compliance program (cont'd)

Formalizing a "program"

- A formal PTC operating model could consist of the following five key elements:
 - Governance
 - Interpretations (e.g., methods, calculations, and assumptions)
 - Process/controls
 - Technology/data
 - People

Practical application and discussion



Polling question #1 – Governance

- What type of organization do you work for?
 - a) Insurance company
 - b) Consulting firm
 - c) Law firm
 - d) Software vendor
 - e) Other

Polling question #2 – Governance

- At your insurance company, is there a designated individual or governance group responsible for PTC (other than providing advice)?
 - a) Yes
 - b) No

Governance

Lessons learned:

- Lack of awareness and/or ownership in assessing/monitoring impact of new legislation and regulatory changes
- No "enterprise-wide," formal PTC policy
- Informal or limited review of issues related to potential non-compliance, policyholder remediation, and potential liability
- Inconsistent and informal process/controls for monitoring PTC compliance across the enterprise

Polling question #3 – Interpretations

Does your company maintain documentation of the methods, assumptions, and interpretations underlying the product tax compliance testing with Sections 7702 and 7702A? Or documentation around administration system development around application of PTC testing requirements?

- a) Yes
- b) No
- c) Don't know

Interpretations

Lessons learned:

- Lack of clearly documented assumptions/interpretations of Sections 7702 and 7702A, such as:
 - Definition of key terms (e.g., premiums paid, material changes)
 - Interpretations of Sections 7702 and 7702A (e.g., aggregation rules, computational assumptions, necessary premium testing)
 - Application of the actuarial tests (e.g., how should the test be designed for monitoring compliance)
- Lack of documented requirements for administering/correcting failed contracts and/or Modified Endowment Contracts (MEC) (e.g., defining "deemed distributions", taxable income, MEC consent forms)

Polling question #4 – Process/controls

- In your insurance company, what functional area do you work in?
 - a) Actuarial/product development
 - b) Operations (new-business, administration, IT, other)
 - c) Tax
 - d) Legal
 - e) Other

Polling question #5 – Process/controls

When products are being developed or enhanced, is there a process in place requiring formal approval/sign-off from a PTC risk perspective?

- a) Yes
- b) No

Polling question #6 – Process/controls

Do you have process/control documents, manuals, or other materials that formalize in detail PTC procedures for various activities of functional areas?

- a) Yes
- b) No

Process/controls throughout the entire product life cycle

Lessons learned:

- Product development:
 - Design of products/features inconsistent with qualification requirements for compliance
 - Continued use of guaranteed expenses in compliance testing premiums (e.g., guidelines) following the enactment of the reasonable expense charge requirements in 1988
 - Continued sales of non-compliant products, e.g., whole life products with cash values (CVs) based on an interest rate $< 3\%$ post Section 7702 effective date, products with mortality guarantees beyond the "sunset" date for various mortality tables, e.g., 1958, 1980 CSO
 - Lack of formal approval/sign-off on PTC

Process/controls throughout the entire product life cycle (cont'd)

Lessons learned:

- New business/policy issue:
 - Failure of sales representatives to carefully explain/market products with features having PTC impacts (potential for inaccurate marketing materials)
 - Failure to execute process/controls for issuing policies due to limited understanding of PTC or other tax law requirements, e.g., what is a MEC and why does it matter? What purpose does a MEC acceptance letter serve?
- Administration:
 - Lack of adequate procedures/controls and escalation points for resources applying premium payments and executing policyholder requested transactions
 - Reliance on manual procedures that occur "outside" of the policyholder administration system that either impact or support product tax compliance testing or the monitoring for compliance with sections 7702 and 7702A

Process/controls throughout the entire product life cycle (cont'd)

Lessons learned:

- Payments/distributions and tax reporting:
 - Failure to properly identify and tax report payments to policyholders and beneficiaries, e.g., "deemed distributions" on MECs, loans/assignments for MECs, aggregation rule for MECs
 - Failure of the administration system to track and maintain the appropriate contract-level data necessary for tax reporting payments/distributions, and properly updating these values when payments/distributions occur, e.g., income, cost basis, 1035s

Polling question #7 – Technology

Is there a formal and detailed process for driving PTC through system implementation or new products or for changes/enhancement of existing products?

- a) Yes
- b) No

Technology

Lessons learned:

- Lack of attention to detail for development of PTC specifications
 - E.g., "too much" flexibility in the admin system, rounding rules, consideration for **all** transactions
- Lack of focus on PTC for product implementation leading to inconsistent treatment across administration, illustration, and other systems (and ad hoc tools)
- Lack of end-to-end ownership of this effort
- Lack of periodic regression testing and validation of system(s) PTC functionality
- Lack of appropriate PTC due-diligence ahead of either a system conversion or acquisition of a block of business
 - Legacy systems interpretations/methods
 - Analysis/storage of historical data, seeding of values in any "target system"
 - Impacts of temporary solutions to administration of policies to be converted or to be acquired

Polling question #8 – People

Does your company have specific educational/training programs for employees and/or agents related to product tax?

- a) Yes
- b) No

Polling question #9 – People

Does your company have a succession plan for those who are currently in the role of providing product tax-related advice or have PTC responsibilities?

- a) Yes
- b) No

Polling question #10 – People

How does your company typically stay current on regulatory changes that may have an impact on PTC?

- a) *Taxing Times* newsletter or other industry publications
- b) Industry meetings
- c) American Council of Life Insurers (ACLI) alerts
- d) More than one of the above
- e) Don't know

People

Lessons learned:

- Lack of awareness and/or an inability of functional area resources to execute their day-to-day jobs, with respect to understanding PTC, such as:
 - Product development actuaries and their knowledge of Sections 7702, 7702A, and 72
 - Customer service representatives fielding calls from policyholders asking about policy transactions with PTC impact
 - Administration resources understanding how systems administer for compliance currently and what historical practices may have existed that caused problems in the past

Polling question #11 – Other/TPA

Do you use Third-Party Administrators (TPA) for administering any/all blocks of policies?

- a) Yes
- b) No

Polling question #12 – General

What do you think the biggest challenge is to maintaining PTC?

- a) Lack of subject-matter expertise/guidance
- b) Complexity of systems/processes
- c) Resource constraints
- d) Not a high priority
- e) All of the above

Polling question #13 – General

How would you rate the overall effectiveness of your organization in managing/mitigating "PTC risk"? (Rating of 5 being very effective.)

- a) 1
- b) 2
- c) 3
- d) 4
- e) 5

Questions



The Taxation Section Presents

Product Tax Seminar

September 13-14, 2018 | The Madison hotel | Washington, D.C.

Session V: Product Implications Arising From Tax Reform, PBR, etc.

Moderator:

Jeffrey Thomas Stabach, FSA, MAAA

Presenters:

Casey Edward Malone, FSA, CERA, MAAA

Kristin R. Norberg, ASA, MAAA

2018 Product Tax Seminar

Product Implications arising
from Tax Reform, PBR, etc.
September 14, 2018



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The United States antitrust laws aim to protect consumers by preserving the free economy and prohibiting anti-competitive business practices; they promote competition. There are both state and federal antitrust laws, although state antitrust laws closely follow federal law. The Sherman Act is the primary U.S. antitrust law pertaining to association activities. The Sherman Act prohibits every contract, combination or conspiracy that places an unreasonable restraint on trade. There are, however, some activities that are illegal under all circumstances, such as price fixing, market allocation and collusive bidding.

There is no safe harbor under the antitrust law for professional association activities. Therefore, association meeting participants should refrain from discussing any activity that could potentially be construed as having an anti-competitive effect. Discussions relating to product or service pricing, market allocations, membership restrictions, product standardization or other conditions on trade could arguably be perceived as a restraint on trade and may expose the SOA and its members to antitrust enforcement procedures.

While participating in all SOA in person meetings, webinars, teleconferences or side discussions, you should avoid discussing competitively sensitive information with competitors and follow these guidelines:

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- **Do** consult with legal counsel before raising any matter or making a statement that may involve competitively sensitive information.

Adherence to these guidelines involves not only avoidance of antitrust violations, but avoidance of behavior which might be so construed. These guidelines only provide an overview of prohibited activities. SOA legal counsel reviews meeting agenda and materials as deemed appropriate and any discussion that departs from the formal agenda should be scrutinized carefully. Antitrust compliance is everyone's responsibility; however, please seek legal counsel if you have any questions or concerns.

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Presenters

- Jeffrey Stabach, Moderator
Ernst & Young LLP
- Kristin Norberg
Symetra Life Insurance Company
- Casey Malone
Milliman LLP

Overview

- Product pricing life cycle
- Overview of key product changes
 - Key Insurance-Related Provisions in the Act
 - LB&I Directive (Aug. 24, 2018) - AG 43/VM-21 and VM-20
- Tax Reform and Pricing
 - An Illustrative Case Study on the Impacts of Tax Reform on Life and Annuity Pricing

Product pricing life cycle

Jeff Stabach, FSA, MAAA



Generic product life cycle process

Governance



★ Changes in underlying methods (e.g., tax reform, principles based reserves) and assumptions can have a significant impact on product

Key Insurance-Related Provisions in the Act

Kristin Norberg, FSA, MAAA



Individual Income Tax

- Individual income tax changes – many temporary
 - Reduced some marginal rates (top rate now 37%)
 - Removed personal exemption
 - Increased standard deduction, but limited many itemized deductions
- ACA individual mandate penalty changed to \$0

Estate and Gift Taxes

- Estate and gift tax changes – temporary
 - Increased exclusion amounts to \$10 million, indexed for inflation
 - Applies 2018-2025, then reverts to \$5 million

Corporate Income Tax

- Broad range of corporate income tax changes
 - Lowered tax rate from 35% to 21%
 - Repealed alternative minimum tax
 - Broadened the tax base – including major changes specific to insurance industry
 - Redesigned taxation of international operations

Insurance Provisions: §807(c)(1) Reserves

- Life insurance reserves
 - Generally 92.81% of CRVM/CARVM reserve
 - Net surrender value floor and statutory cap by contract
 - Still exclude:
 - Deficiency reserves
 - Asset adequacy testing (AAT) reserves
 - Reserves attributable to deferred and uncollected (D&U) premiums (if premiums not included in income)
 - Special rule for variable contracts

Insurance Provisions: §807(c)(2) Reserves

- Unpaid losses for property/casualty insurance, cancellable A&H other than disability
 - Discounted using rate based on corporate bond yield curve
 - Rate to be determined by Treasury

Insurance Provisions: §807(c)(3) Reserves

- Reserves not involving life/A&H contingencies
 - 100% of reserve using NAIC maximum interest rate
 - Net surrender value floor by contract
 - Still exclude AAT reserves

Insurance Provisions: §848 DAC Tax

- Increased capitalization rates by ~20%
- Increased amortization period to 15 years (from 10)

Product	Prior Law	New Law
Non-qualified annuities	1.75%	2.09%
Group life	2.05%	2.45%
Individual life, individual A&H	7.70%	9.20%

Dividends-Received Deduction

- General corporate DRD reduced to 50% from 70%
- Life insurance company share changed to flat 70%

Other Corporate Base Broadeners

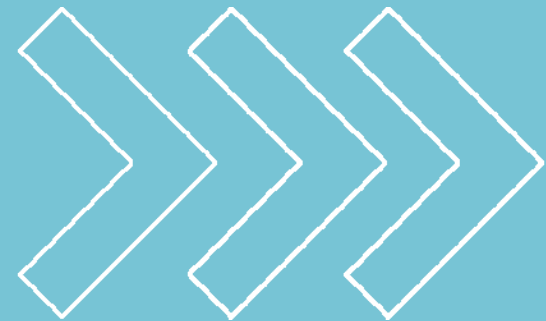
- Repealed small life insurance company deduction
- Changes to net operating losses
 - No carryback, indefinite carryforward
 - Utilization limited to 80% of taxable income
- Miscellaneous deductions
 - Highly compensated employees, fringe benefits, meals and entertainment
- Interest expense deduction limitation

Impact on Insurance Company Capital

- Required capital is higher beginning in 2018 due to tax rate change
 - Example: Company needs \$79 to cover a \$100 pre-tax loss, instead of \$65 → 21.5% increase in required capital
- Changing target RBC ratios?

LB&I Directive (Aug. 24, 2018) AG 43/VM-21 and VM-20

Kristin Norberg, FSA, MAAA



The Directive

- Addresses tax years 2010-2017
- Contracts in scope:

Contract types	Issue dates	If subject to these statutory reserve requirements
Variable annuities	12/31/2009-12/31/2017	AG 43 or VM-21
Variable annuities with guaranteed living benefits	1/1/1981-12/30/2009	AG 39 (pre-2010 tax years) and AG 43 (post-2009 tax years)
Individual life insurance	2017	VM-20, if company reported under VM-20 in 2017 Annual Statement

Accepted Method: Variable Annuities

$$\text{FPR} = \text{Tax SSA} + 96\% * \text{Max}(0, \text{Allocated Stat CTE} - \text{Stat SSA})$$

- Definitions

- FPR = Federally prescribed reserve under pre-TCJA §807(d)(2)
- Tax SSA = AG 43 standard scenario amount adjusted for pre-TCJA §807(d)(2) requirements (i.e., mortality and interest)
- Allocated Stat CTE = AG 43 conditional tail expectation amount allocated to the contract
- Stat SSA = Statutory AG 43 standard scenario amount

Accepted Method: Life Insurance

$$\text{FPR} = \text{Tax NPR} + 96\% * \text{Max}(0, \text{Allocated Stat DR/SR} - \text{Stat NPR})$$

- Definitions
 - NPR = VM-20 net premium reserve, reduced by any amounts attributable to D&U premiums
 - Tax NPR includes pre-TCJA §807(d)(2) adjustments; Stat NPR does not
 - Allocated Stat DR/SR = VM-20 deterministic reserve or stochastic reserve allocated to the contract

Other Provisions

- Adjustments are made on catch-up basis on 2017 tax return
- Consistency requirements
- Certification Statement to be filed with 2017 tax return
- Detailed rules for application of pre-TCJA §807(f)
- No inferences should be drawn allowing deduction of AAT or deficiency reserves, or regarding TCJA §807

Tax Reform and Pricing

An Illustrative Case Study on the Impacts of Tax Reform on Life and Annuity Pricing

Casey Malone, FSA, CERA, MAAA



Product Types

- Current assumption universal life (CAUL)
- Par whole life (WL)
- Term under Valuation Manual Chapter 20 (VM-20) (TermVM20)
- Term under peak statutory (XXX) and Actuarial Guideline (AG) 48 (TermAG48)
- Indexed universal life (IUL)
- Fixed indexed annuity (FIA)

Tax Reform Key Changes

Proxy DAC

- Amortization extended from 10 to 15 years.
- Rate increased from 7.7% to 9.2% for non-group life, 1.75% to 2.09% for annuities.

Tax Reserves

- 92.81% scalar applied to stat reserves, floored at CSV.
- Assumes that tax reserve basis post-reform = stat reserve basis pre-reform

Tax Rate

- Reduction in the FIT rate from 35% to 21%

RBC Factors

- Note: As of the time of the study, this was still an open issue.
- Increase RBC factors by a scalar of $(1 - 0.21)/(1 - 0.35)$, or a 21.5% increase.
- This was a worst case interpretation.

Life RBC Tax Proposal for YE 2018

Adopted by the Capital Adequacy Task Force (CADTF)

Risk	Type	After Tax Factor Change
C-1	<ul style="list-style-type: none">▪ Bonds and Bond Like▪ Other Assets▪ Reinsurance Credit Risk	+10.8% +21.5% +17.9%
C-2	<ul style="list-style-type: none">▪ Life▪ Other	+17.9% No Change
C-3		No Change
C-4		No Change

Current Assumption UL

Composite Profit Results

- Profitable back-loaded plan with statutory and tax reserves pre-reform assumed to equal the average of the account value and the cash surrender value—the “California” method

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	15.2%	6.3%
CHANGE DAC TAX	13.7%	5.9%
CHANGE TAX RESERVES	12.2%	5.6%
CHANGE TAX RATE	17.1%	8.1%
CHANGE RBC	15.4%	7.9%

Current Assumption UL

Composite Profit Results – By Funding Level

	BEFORE TAX REFORM		AFTER TAX REFORM		INCREASE	
	IRR	PROFIT MARGIN	IRR	PROFIT MARGIN	IRR	PROFIT MARGIN
SINGLE PAY	12.5%	5.3%	12.5%	6.6%	0.1%	1.3%
7-PAY	14.7%	6.2%	14.9%	7.9%	0.2%	1.7%
LEVEL-PAY WL	16.9%	6.5%	17.2%	8.2%	0.3%	1.7%
20-YEAR TERM	20.7%	9.2%	21.1%	11.3%	0.5%	2.1%

Participating Whole Life

Composite Profit Results

- 20-pay premium pattern
- Stat reserve = CRVM at 3.5%
- Guaranteed CV based on non-forfeiture rate of 4.5%

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	10.0%	3.4%
CHANGE DAC TAX	9.3%	2.7%
CHANGE TAX RESERVES	6.9%	-0.2%
CHANGE TAX RATE	9.1%	3.0%
CHANGE RBC	8.9%	2.8%

- Product adjustments: reduce the non-forfeiture rate to 4%, increasing cash values and reduce overall dividend scale by 8%. This helps mute the tax reserve change impact.

Term under VM-20

Composite Profit Results

- Premiums under the VM-20 approach are approximately 10% higher than premiums under AG48.

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	9.6%	5.1%
CHANGE DAC TAX	9.1%	4.8%
CHANGE TAX RESERVES	8.8%	4.6%
CHANGE TAX RATE	10.1%	6.6%
CHANGE RBC	9.8%	6.5%

- Company can decrease premiums by 3% to maintain pre-reform profit margin.

Term under AG48

Composite Profit Results

- XXX statutory reserves in excess of the AG48 primary security level will be ceded to a captive reinsurer and backed by a letter of credit.
- Direct company retains the full XXX tax reserve, which exceeds the AG48 primary security level.

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	26.5%	9.5%
CHANGE DAC TAX	25.7%	9.1%
CHANGE TAX RESERVES	22.4%	7.9%
CHANGE TAX RATE	9.9%	4.0%
CHANGE RBC	8.7%	3.6%

- Tax reform significantly reduces the tax benefit of AG48 financing.
- To maintain profit margin after tax reform, premiums increase by 10%. May accelerate adoption of VM-20 for term

Indexed UL

Composite Profit Results

- Target level premium to age 65, moderate withdrawals to 100
- Stat reserves equal the average of AV and CSV

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	10.0%	5.2%
CHANGE DAC TAX	9.4%	4.8%
CHANGE TAX RESERVES	8.7%	4.5%
CHANGE TAX RATE	10.2%	6.5%
CHANGE RBC	10.0%	6.4%

- The impact on IRR is negligible, so some companies may not choose to change pricing.
- If lower IRR is acceptable, COI could be reduced 8% to maintain pre-reform profit margin.

Fixed Indexed Annuity

Composite Profit Results

- GMWB with 8% rollup, max w/d rates of 5%/6%/7% at ages 60/70/80
- 7 year surrender charge period with maximum charge of 7%

	IRR	PROFIT MARGIN
BEFORE TAX REFORM	10.2%	5.9%
CHANGE DAC TAX	10.1%	5.9%
CHANGE TAX RESERVES	8.8%	5.0%
CHANGE TAX RATE	10.6%	7.5%
CHANGE RBC	10.0%	7.4%

- Like IUL, the impact on IRR is small, so some companies may not choose to change pricing.
- If lower IRR is acceptable, the option budget (pricing spread) could be increased (decreased) by 21 bps to maintain pre-reform profit margin.

Pricing changes to maintain profit margin

Discount rate of 5%

Product	Pricing change
CAUL	Decrease COI by 8%
Par WL	Decrease CV interest rate by 0.5%, cut dividends by 8%
Term (VM-20)	Decrease premiums by 3%
Term (AG 48)	Increase premiums by 10%
IUL	Decrease COI by 8%
FIA	Increase option budget by 21 bps

Conclusion

- The overall impact of Tax Reform is modest, but positive, for most of these illustrative product types.
- TermAG48 is the most significant exception, where the tax leverage of reserve financing drops in value significantly.
- While the tax benefit of the rate drop is significant, this is largely offset by the RBC, DAC tax, and tax reserve changes.

Questions?

