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From the Chair Shared Knowledge

By Tony R. Litterer

In the Disney Pixar animated short film *Piper*, we first see a recently hatched sandpiper chick who is ready to start to forage for food. With a little encouragement from his parent, we see the chick take his first steps into a new world. The parent demonstrates how food may be found, and while the chick is busy enjoying the fruits of his newfound talent, he fails to notice the incoming surf. In the next scene, we see the chick with his feathers a bit ruffled and shivering from the unexpected bath he just endured. The next attempt to forage requires more coaxing from his parent. After all, his first experience was less than successful and left him afraid of what was out there.

Eventually, hunger wins out and he once again steps onto the beach. As he slowly makes his way to the waterline, he befriends a young hermit crab. While the chick is filled with wonder of his new friend, he once again fails to see the incoming surf. Somewhat akin to a deer in the headlights of a car, the chick freezes, not knowing what to do. Just before the surf is upon him, he realizes his friend has burrowed himself into the sand as a means of protecting himself from the onslaught of water. The chick mimics his friend and burrows his way into the sand. As the water engulfs them, they are quickly submerged and the relative peace of being underwater without the torrent of cascading water brings a new sight to behold. The hermit crab raps on the beak of the chick. The chick opens his eyes to behold a world he never would have seen had it not been for his friend. When the surf is high, all of the crustaceans become visible.

As soon as the surf recedes, the chick quickly digs up the crustaceans, enough food for himself and other sandpipers. No longer scared of the surf, the chick becomes a talented member of the flock.

Relating this story to any professional career path is simple. Along the way we gain knowledge from our experiences and from the people we meet. For many actuaries, the knowledge gained over the years comes from self-study and a handful of knowledgeable leaders, supervisors, colleagues and friends. The value placed on the knowledge varies for each individual, and



although someone may be intelligent, it is more meaningful to apply the knowledge in an effective manner.

Over the past three years, being involved with the Society of Actuaries (SOA) Taxation Section has taught me what is needed to prepare for an industry conference, how to lead a diverse group of individuals with a common goal and how to delegate and share responsibility. Being involved has added perspective and purpose that makes attending industry conferences more valuable. As a result of greater involvement I have had the opportunity to work with many experts in the field of insurance taxation. In many ways, I see my evolution has been much like that of the young, inexperienced sandpiper. The combined knowledge of the section members, past and present section council members and the numerous friends of the section are a treasure trove from which to draw support to better understand insurance taxation.

Volunteering for an SOA section does require commitment. However, my personal belief is that there is value in running for and accepting a seat on a section council. The experience can be rewarding for the newly designated Associate or a seasoned Fellow of the Society of Actuaries. There is always something more to learn and different perspectives to understand. Applying tax knowledge is part of my daily responsibility. Becoming the hermit crab for the next generation of sandpipers is also my responsibility. If you wish to learn more about insurance taxation, please attend one of the many sessions the Taxation Section sponsors at the industry meetings or express interest in becoming a council member. We are here to help you grow. ■

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

Why Do Limitations Apply to Owners of Life Insurance Contracts, Particularly COLI?

By Bryan W. Keene and Mark S. Smith

It is well known that permanent, cash value life insurance contracts can provide significant income tax benefits for their owners and beneficiaries. For example, the “inside buildup” generally grows tax-deferred, meaning interest or earnings credited to the contract’s cash value generally are not taxed unless an amount is received during the insured’s lifetime. If lifetime distributions occur, they are governed by the income ordering rules in Section 72,¹ which often prescribe basis-first treatment for the amounts received.² In addition, death benefits paid to the beneficiary generally are excludable from gross income pursuant to Section 101(a). Thus, if the owner does not receive any distributions during the insured’s lifetime, the interest or earnings credited to the cash value are never subjected to federal income tax.

Over the years, Congress has taken action to limit the tax benefits of life insurance, either generally or in particular contexts. In terms of general limitations, actuaries are well aware of the congressional enactments throughout the 1980s that added Sections 7702 and 7702A to the Code.³ Those rules apply to life insurance contracts generally, rather than to particular uses or purchasers, and are meant to limit the foregoing tax benefits to contracts that strike a prescribed balance between pure insurance protection and investment orientation.⁴

Congress also has targeted limits on particular types of life insurance arrangements—principally those involving business uses of the product. These limits are less actuarial in nature than the definitional rules of Sections 7702 and 7702A. As a result, the members of the Society of Actuaries (SOA) may

have had fewer occasions to become familiar with these additional rules or why they exist. This article attempts to remedy this by providing a brief survey of the history and application of some of these provisions.

In particular, the article surveys the limitations under Section 264(a) on business deductions for premiums and interest expense related to life insurance, the similar limitations under Section 264(f) for unrelated interest expense of businesses that own life insurance, the limitations under Section 101(j) on the excludability of death benefits under employer-owned life insurance contracts and the recently enacted rules for life settlement transactions. Finally, the article touches on the importance of knowing the effective dates of these various congressional enactments and the risk of triggering those effective dates by making “material” changes to existing contracts.

SECTION 264(a): BUSINESS DEDUCTIONS FOR PREMIUMS AND INTEREST EXPENSE

Since the dawn of the federal income tax, life insurance death benefits have been excludable from gross income for individual and corporate beneficiaries alike. In February 1913, the states ratified the 16th Amendment to the Constitution, which explicitly empowered Congress to impose income taxes without apportionment among the states. About eight months later, Congress enacted the first federal income tax statute, known as the Revenue Act of 1913, which imposed an income tax on individuals and corporations.⁵ The Act’s provisions on individuals expressly referenced, for the first time, the tax-free treatment of life insurance death benefits.⁶ The Act’s provisions on corporations cross-referenced the provisions defining income for individuals, thereby indirectly providing that death benefits were excludable for corporate beneficiaries too.⁷

About a year later, however, the Treasury Department announced that it would interpret the law as *not* extending this exclusion to corporations.⁸ Treasury’s rationale was that corporations could deduct the premiums paid for the life insurance from their gross incomes as business expenses.⁹ In other words, if the death benefits were excludable and the premiums deductible, corporations could fund a tax-exempt asset with tax-deductible money. A few years later Treasury again weighed in on the premium deductibility issue, announcing that corporations could no longer deduct life insurance premiums as business expenses but could recover any non-deducted premiums tax-free from the death proceeds, with the remaining proceeds still being taxable pursuant to Treasury’s earlier interpretation.¹⁰ The Supreme Court and Congress overturned Treasury’s interpretation of the death benefit exclusion a few years later, restoring it for corporate beneficiaries.¹¹ However, the concept that premiums should be nondeductible endured and was codified into the tax law, ultimately becoming Section 264(a)(1) of today’s Code.

Concern over tax deductions associated with tax-exempt or tax-deferred types of income lies at the heart of the limitations imposed under Section 264, as well as other provisions of the Code dealing with similar situations.¹² With respect to life insurance, when Congress would act to preclude a tax benefit for one type of cost, another would surface and Congress would act again, adding further provisions to Section 264 to address them. As some commentators quipped, “the same basic arbitrage transaction of incurring deductible interest expense to buy nontaxable interest income or other earnings persists to this day, rising from the dead time and again like a phoenix from the ashes, albeit more and more tightly constrained by Congress.”¹³ The constraints Congress enacted in Section 264(a) can be summarized as follows.

Section 264(a)(1)

As noted earlier, this provision focuses on premiums paid for life insurance contracts. Specifically, it denies a deduction for “[p]remiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.” Originally, the provision was limited to policies covering officers, employees and persons with financial interests in the taxpayer’s trade or business. In 1997, however, a large lender reportedly planned to acquire policies insuring the lives of its debtors.¹⁴ Given the scope of Section 264(a)(1) at the time, the premiums would have been deductible. Congress reacted by expanding the provision’s scope to deny the deduction regardless of whose life the policy insures.¹⁵ Congress also added Section 264(f) to the Code as part of the same legislation, which is discussed later. Today, the primary interpretive questions involving Section 264(a)(1) relate to when a taxpayer will be “indirectly” a beneficiary under a policy, which (unsurprisingly) courts and the Service have interpreted quite broadly.¹⁶

Section 264(a)(2)

This provision focuses on interest expense relating to single premium policies. Specifically, it denies a deduction for “[a]ny amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.” Whether indebtedness is incurred or continued to purchase or carry a policy is a question of fact. A contract is treated as a single premium contract if (1) substantially all of the premiums are paid within four years of purchase, or (2) an amount is deposited with the insurer for payment of a substantial number of future premiums.¹⁷ This definition presents interpretive questions about what “substantially all” and “substantial number” mean, particularly in the context of flexible premium universal life insurance policies, which did not exist when these rules were enacted.

In that regard, Congress enacted the predecessor of Section 264(a)(2) in 1942 in reaction to transactions occurring at the



time in which taxpayers would borrow money to purchase single premium policies and deduct the associated interest expense while also enjoying the tax benefits normally afforded to life insurance.¹⁸ In other words, taxpayers were achieving tax benefits similar to those Congress had previously denied for direct premium payments. If the premiums themselves were nondeductible, taxpayers could achieve a similar tax benefit by borrowing to pay the premiums and deducting the interest. The transactions at the time involved single premium policies, so that is what Congress addressed. However, taxpayers soon moved on to other forms of transactions involving the use of deductible interest to buy life insurance, so the story continued.

Section 264(a)(3)

This provision focuses on interest expense relating to policies, other than single premium policies, involving systematic borrowing to purchase or carry the policies. Specifically, it denies a deduction for interest paid or accrued “to purchase or carry a life insurance ... contract (other than a single premium contract ...) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).” Exceptions to the disallowance rule apply for (1) transactions that do not involve borrowing to

pay premiums for at least four of the first seven annual premiums (the so-called “4 out of 7 test”), (2) certain de minimis borrowing, (3) borrowing due to certain unforeseen circumstances and (4) borrowing in connection with the taxpayer’s trade or business (as opposed to borrowing to purchase or carry the policies). Congress enacted these provisions in 1964 in response to so-called minimum deposit plans.¹⁹ The plans were structured to avoid the limitations on single premium policies under Section 264(a)(2) by requiring a series of scheduled premiums funded by borrowing against the policy, either directly or indirectly via collateral assignments. The taxpayer then would deduct the interest expense and thereby achieve the desired tax benefit, at least until Congress acted in 1964.

Since the dawn of the federal income tax, life insurance death benefits have been excludable from gross income for individual and corporate beneficiaries alike.

Section 264(a)(4)

This provision broadly denies deductions for interest expense “with respect to” life insurance policies, and it was the first to focus on so-called broad-based corporate-owned life insurance (COLI). Specifically, it denies a deduction for interest paid or accrued “with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual. ...” The reference to interest “with respect to” a policy appears to be directed at policy loans, but this is not made explicit in the statute.

As originally enacted in 1986, the provision applied only to coverage on employees and officers, or individuals with a financial interest in the trade or business.²⁰ In addition, the disallowance rule applied only to the extent that the aggregate indebtedness with respect to policies covering any such person exceeded \$50,000.²¹ The 1986 legislative history indicates that Congress enacted these provisions out of concern that when a business owner “borrows against a life insurance policy, the loan reduces the death benefit,” with the result that “much of the death benefit promised to an employee is illusory” and the employee ends up “depending upon the credit of his employer to the extent of the indebtedness.”²² Thus, the original enactment was intended to “encourage businesses to provide effective death benefits to employees.”²³

The purpose of the provision evolved, however, with amendments that Congress made in response to the marketplace

reaction to the 1986 law. Specifically, the marketplace created broad-based COLI plans in which corporations would purchase life insurance “covering hundreds, thousands, or even hundreds of thousands of employees ... in order to maximize the tax arbitrage of deducting [policy loan] interest that is credited, tax-free, to the organization’s own insurance contract.”²⁴ The legislative history characterized this practice as “the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest,” which Congress viewed as inconsistent with “general principles of accurate income measurement under which ... expenses, such as interest, are not deducted from income if they are costs of accretions to wealth that are not included in income.”²⁵

Congress responded in 1996 by amending Section 264(a)(4) to eliminate interest deductions connected with leveraged COLI plans in most instances, but it continued to “grandfather” from its application contracts purchased on or before June 20, 1986, subject to one change regarding deductible interest rates (described later in this article).²⁶ The 1996 legislation disallowed all deductions for interest paid on indebtedness related to life insurance contracts purchased after June 20, 1986, while retaining an exception for such contracts if they insured the lives of “key persons.” The key person exception, contained in Section 264(e)(1) (formerly Section 264(d)(1)), allowed interest deductions for such contracts only to the extent that the related indebtedness did not exceed \$50,000 per key person insured. The 1996 legislation defined a “key person” as an officer or 20-percent owner of the corporate policyholder. This legislation effectively eliminated much of the appeal of leveraged COLI plans. As to the pre-June 20, 1986, contracts otherwise grandfathered from the Section 264(a)(4) change, the 1996 legislation added Section 264(e)(2) (formerly Section 264(d)(2)) to impose a limit on the interest rate that could be used in determining the deductible amount of interest on the borrowing for any month beginning after Dec. 31, 1995. In 1997, Congress further amended Section 264(a)(4) to provide that no deduction is allowed for policy loan interest under a policy covering any individual, whether an employee, officer or financially interested person.²⁷ The 1996 exception for “key person” coverage survived this legislation and continues to be available.

SECTION 264(f): PRO RATA ALLOCATION OF INTEREST TO POLICY CASH VALUES

After the 1986 enactment of Section 264(a)(4) and the subsequent amendments thereto, one might have assumed that Section 264(a) was sufficient to address any tax policy concerns about companies receiving tax deductions for costs to generate tax-preferred income under life insurance contracts. Premiums were wholly nondeductible under Section 264(a). Interest was nondeductible if paid or incurred to purchase or carry single premium life insurance contracts, and it was generally

nondeductible if pursuant to a plan of purchase of life insurance policies that contemplated systematic borrowing, or if incurred “with respect to” life insurance policies. This is not, however, the end of the story.

As noted earlier, in 1996 and 1997 Congress became concerned about a program under which a large, leveraged holder of debt, particularly mortgages, would acquire policies insuring the lives of the debtors. Inside buildup on the policies would not be subject to federal income tax when it was earned. If held to maturity, death benefits on the policies would be wholly excludable from gross income. Even though no borrowing was directly associated with the policies themselves, the financial institution was highly leveraged. In an indirect sense, one might characterize the arrangement as having potential to fund tax-preferred income with tax-deductible interest. For this reason, Congress concluded that additional limitations were needed to prevent “tax arbitrage” in such situations.²⁸

The Taxpayer Relief Act of 1997 added Section 264(f) to the Code to address this situation.²⁹ Under Section 264(f), no deduction is allowed for that portion of a taxpayer’s interest expense that is “allocable to unborrowed policy cash values.” For this purpose, the allocable portion of a taxpayer’s interest expense is determined by applying to the company’s interest expense a ratio equal to the average unborrowed cash values of life insurance and annuity contracts, divided by that same amount plus the average adjusted basis of all the company’s other assets. The provision includes exceptions for policies that cover the lives of 20-percent owners, officers, directors or employees, a list that is similar to (but in some respects broader than) the list of individuals excepted from the interest expense disallowance rule of Section 264(a)(4). It also carves out policies that already are subject to current income inclusion and policies that are held by a natural person. Finally, the provision applies only to policies issued after June 8, 1997, the date of enactment.

Because Section 264(f) operates as a partial disallowance of interest expense, its impact generally is limited to taxpayers with significant debt. Section 264(f)(8)(B) specifies that the provision does not apply to an insurance company. At the same time Congress added Section 264(f), however, it amended pre-existing rules under Sections 807(a) and (b) and Section 832(b) (5) to reduce insurers’ tax-deductible reserves by an amount based on policy cash values on policies “to which Section 264(f) applies.” As a practical matter, insurance companies thus are subject to a similar disallowance. The relationship between these insurance-specific provisions on the one hand and Section 264(f) on the other was the subject of guidance that the Service issued in 2007.

That year, the Service issued PLR 200738016, concluding that the Section 264(f) exception for 20-percent owners, officers, directors or employees did not apply to life insurance contracts owned by an insurance company (I-COLI contracts), because those exceptions appear only in Section 264(f), which by its terms does not apply to insurance companies. This conclusion could present an obvious problem for insurers, which often insure the lives of their employees for nontax business reasons. The conclusion in the PLR was sufficiently controversial that, concurrent with the public release of the PLR several months after it was first issued, the Service also issued Rev. Proc. 2007-61,³⁰ addressing the issue differently, and a modification of the PLR (numbered consecutively as PLR 200738017) based on the new revenue procedure. Rev. Proc. 2007-61 was surprising in the sense that, rather than simply apply the same exception for employees that applies under Section 264(f), it excepted only 35 percent of those employees (discussed later in this article). As a practical matter, this was sufficient to provide relief in most cases, though the decision not to simply follow Section 264(f) in the first place created confusion.³¹

The 1997 *pro rata* interest disallowance of Section 264(f) and the subsequent developments on I-COLI represent the most recent activity on deduction limitations on COLI, but they are not the end of the story.

SECTION 101(j): COLI BEST PRACTICES

In the mid-1990s, the Service undertook a campaign to challenge interest deductions by corporations with large blocks of COLI insuring the lives of their employees. Much of that business either predated the limitations of Section 264(a)(4) or complied with Section 264 as in effect when the programs were established. The Service challenged the arrangements based on long-established standards for determining whether an arrangement lacks “economic substance” or otherwise should be treated as a “sham transaction” for federal income tax purposes. The Service expressed concern that on a current basis, the companies claimed a deduction for interest on policy loans, yet included nothing in income as amounts were credited to policy cash values. In the Service’s view, the net income tax benefits associated with the arrangements dwarfed any economic returns that the arrangements otherwise would produce.

The Service’s efforts resulted in high-profile litigation. In *Winn-Dixie Stores, Inc. v. Commissioner*,³² *Internal Revenue Service v. CM Holdings, Inc.*,³³ and *American Electric Power, Inc. v. U.S.*,³⁴ the Service argued that the broad-based COLI arrangements at issue were shams or lacked economic substance. The 11th, third and sixth circuits, respectively, ruled for the Service. In contrast, in *Dow Chemical Company v. U.S.*,³⁵ the district court reached a different conclusion based on its factual determination that the policies at issue were not “empty



transactions entered into for the sole purpose of generating a deduction.” A full discussion of the COLI litigation is beyond the scope of this article; note, however, that tax determinations of sham and economic substance are highly factual and depend on the circumstances in each case.

The COLI cases drew attention to the practice of many large employers to maintain blocks of life insurance on large numbers of employees. Although the business purpose of the strategy was well known among companies and practitioners, in the popular press the practice sometimes was referred to as “janitor insurance”³⁶ and “dead peasant insurance.”³⁷ In turn, this led to a broader public policy debate about appropriate limitations, or best practices, around COLI. The deduction limitations of Section 264, although effective in preventing tax deductions with regard to tax-preferred income generated by COLI, did not address corporate behavior that one might characterize as “best practices” when insurance was purchased on the lives of employees.

Against this backdrop, Congress enacted Section 101(j) in the Pension Protection Act of 2006.³⁸ Broadly, that provision imposes a limit on the number and types of employees whose lives may be insured, a requirement that employees be notified that their lives are being insured and a requirement to obtain affirmative employee consent of the coverage. An employer that purchases life insurance on employees without complying with Section 101(j) risks paying tax on death benefits that exceed the premiums and other amounts paid for the contract.

In that regard, pursuant to Section 101(j), the exclusion for death benefits under an employer-owned life insurance contract applies only if the insured was an employee within 12

months of death, was a director or was a highly compensated employee or individual (basically, top 35 percent) as defined when the contract was issued, or if the proceeds are used to pay family members of the insured or to purchase an interest in the employer from the family of the insured. Most important, these exceptions apply only if tax-prescribed notice and consent requirements are met. That is, an employee

- must be notified in writing that the employer intends to insure the employee;
- must be notified of the maximum face amount of the insurance;
- must provide written consent to the insurance; and
- must be notified that the employer will be a beneficiary of any proceeds payable upon death.

A failure to meet these notice and consent requirements can be difficult to cure and may result in a significant portion of the death benefits becoming taxable to the employer. In Notice 2009-48,³⁹ the Service provided guidance in Q&A format addressing how these requirements may be met and, in limited cases, how a failure may be cured.⁴⁰

LIFE SETTLEMENTS AND TRANSFERS FOR VALUE

As noted earlier, the general income tax exclusion of life insurance death benefits from gross income dates back to the Revenue Act of 1913,⁴¹ which for the first time imposed an income tax on individuals pursuant to the 16th Amendment. A longstanding rule, however, taxes a portion of such death benefits if there was a transfer of the underlying policy for a valuable consideration.

Section 101(a)(2) provides that if there has been a transfer of a life insurance contract for a valuable consideration (a “transfer for value”), the amount excluded from gross income does not exceed the actual value of the consideration paid for the policy plus premiums and other amounts (including interest) that are subsequently paid. Thus, if there has been a transfer for value, the amount of death benefits representing gain, or income, is included in gross income. Importantly, exceptions to the transfer-for-value rule apply in a transferred-basis transaction (basically, a transaction such as a corporate transaction that itself is tax-free), or a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer. As a practical matter, the exceptions to the transfer-for-value rule accommodated many run-of-the-mill business transactions in which life insurance policies were not a central part of the transaction.

The growth of a secondary market in life insurance policies—life settlements—was viewed as posing unique social and tax policy issues. In 2009, the Service published two revenue rulings addressing tax issues that arise for an individual who sells a life insurance policy to an investor,⁴² and for an investor who purchases a life insurance policy and either resells it or holds it until a death benefit is received.⁴³

In response to concerns that transactions may be structured to avoid a “transfer” in the first place, in 2017 Congress amended Section 101(a) to make those exceptions inapplicable if there has been a “reportable policy sale.” A “reportable policy sale” is defined as the acquisition of an interest in a life insurance contract “directly or indirectly” if the acquirer has no substantial family, business or financial relationship with the insured apart from the acquisition of the contract. The provision goes on to explain that an “indirect” transfer of a policy includes the acquisition of an entity that owns the policy.

On March 22, 2019, the Service filed proposed regulations with the Federal Register to interpret this provision. The proposed regulations define what is a substantial family, business or financial relationship with the insured apart from the acquisition of the contract. The proposed regulations also explain the circumstances under which the transfer of an ownership interest in an entity that, in turn, owns life insurance contracts may be treated as an indirect transfer of those contracts and thus a reportable policy sale. The issue is particularly important in the context of acquisitions of a business.

IMPORTANCE OF EFFECTIVE DATES AND GRANDFATHERED CONTRACTS

Each of the Internal Revenue Code changes discussed in this article came with its own effective date:

- Section 264(a)(3) is effective for contracts purchased after Aug. 6, 1963.
- Section 264(a)(4) is effective for contracts purchased after June 20, 1986, in tax years ending after that date.
- Section 264(f) applies to contracts issued after June 8, 1997, in tax years ending after that date.
- Section 101(j) applies to life insurance contracts issued after Aug. 17, 2006, except for a contract issued after that date in a Section 1035 exchange for a contract issued before that date.
- Section 101(a)(3) applies to “transfers” after Dec. 31, 2017.

Evaluating the treatment of any interest paid, or any death benefits received under contracts that are part of a block of COLI contracts, thus requires an analysis of when the contracts

were “issued,” “purchased” or “transferred.” For example, for an existing block of COLI business, which contracts were issued before and after the relevant dates? For those contracts issued after the relevant dates, did the contracts comply with the provisions and, if not, were interest deductions and death benefits received accounted for properly? Were there tax-free exchanges of the policies and, if so, did the exchanges result in treatment as reissued?

These issues are important to the management of an existing block of COLI business and to the acquisition of a target with a block of existing COLI. An entire supplement to the May 2012 issue of *TAXING TIMES* is dedicated to a discussion of circumstances under which changes to an existing contract cause the contract to be treated as newly issued or purchased for purposes of Sections 101(f), 7702 and 7702A.⁴⁴ Much of that discussion also is relevant to the provisions imposing limitations on COLI.

CONCLUSION

As pointed out earlier, the limitations that apply to COLI are less actuarial in nature than the definitional requirements of Sections 7702 and 7702A and may not be immediately transparent to a product actuary. At the same time, the limitations are important to business purchasers of life insurance because they are part of the environment in which contracts are sold. Though seemingly complex, arbitrary and overlapping, the limitations should be evaluated based on their purpose. Broadly, that purpose is to limit the ability of a company to deduct costs associated with an investment that produces tax-preferred income. Limitations on deductions for premiums, limitations on deductions for interest and even limitations on the population of individuals whose lives may be insured may best be understood as contributing to a regime that is intended to tax life insurance contracts appropriately and to avoid conferring any tax advantage beyond what Congress has considered appropriate. ■

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ENDNOTES

- 1 References to "Section" are to sections of the Internal Revenue Code of 1986 (the Code), as amended.
- 2 The basis-first rule applies only to life insurance contracts that are not modified endowment contracts (MECs) as defined in Section 7702A. MECs are subject to an income-first ordering rule for lifetime withdrawals, and policy loans taken under MECs, as well as collateral assignments of MECs, are treated as withdrawals for this purpose. A 10 percent additional tax also applies generally to MEC withdrawals. See Sections 72(e)(2)(B), (e)(5)(C), (e)(10), and (v).
- 3 See Pub. L. No. 98-369 § 221(a) (1984) (adding Section 7702 to the Code) and Pub. L. No. 100-647 § 5012(c)(1) (1988) (adding Section 7702A to the Code).
- 4 John T. Adney, *Why Section 7702 (and 7702A, too)? Some Historical Perspectives*, *TAXING TIMES*, Vol. 14, Issue 1, at 10 (Feb. 2018).
- 5 Act of October 3, 1913, ch. 16, 38 Stat. 166.
- 6 *Id.* at 167.
- 7 *Id.* at 172.
- 8 T.D. 2090, 16 Treas. Dec. Int. Rev. 269, 281 (1914).
- 9 *Id.*
- 10 T.D. 2519, 19 Treas. Dec. Int. Rev. 150 (1917).
- 11 See Section 265 (disallowing certain expenses and interest relating to tax-exempt income); *Supplee-Biddle Hardware Co. v. United States*, 265 U.S. 189 (1924), *aff'd* 58 Ct. Cl. 343 (1923); and Revenue Act of 1921, ch. 136, 42 Stat. 227, 238.
- 12 For example, the Code includes various "proration" rules that apply to banks and insurance companies, which deny deductions for the portion of these corporations' otherwise-allowable deductions that the rules deem allocable to tax-exempt or tax-deferred assets. See Section 265(b) (banks), Section 812 (life insurance companies), and Section 832(b)(5)(B) (property and casualty insurance companies). More generally, Section 265(a) denies certain otherwise-allowable deductions relating to the production of tax-exempt income, including "[i]nterest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt" from tax. Section 265(a)(2).
- 13 Kirk Van Brunt and Mark E. Griffin, *Income Taxation of Life Insurance and Annuity Contracts*, 529 *TAX MANAGEMENT PORTFOLIOS*, at 83 (2019).
- 14 See Staff of the J. Comm. on Tax'n, 105th Cong., General Explanation of Tax Legislation Enacted in 1997, at 271–272 (J. Comm. Print 1997).
- 15 Pub. L. No. 105-34 § 1084(a) (1997). At the same time, Congress added two exceptions to Section 264(a)(1), one for annuity contracts described in Section 72(s)(5) (regarding qualified plans and IRAs) and one for annuity contracts to which Section 72(u) applies (denying tax deferral for certain nonqualified annuities held by nonnatural persons). *Id.* at § 1084(b).
- 16 See, e.g., Treas. Reg. Section 1.264-1(b) (partner takes out a policy on his life and irrevocably names his partner as the sole beneficiary to induce his partner to remain as such); *Carbine v. Comm'r*, 777 F.2d 662 (11th Cir. 1985), *aff'd* 83 TC 356 (1984) (policy used as collateral for bank loan to company in which insured was a shareholder); *Brock v. Comm'r*, T.C. Memo 1982-332 (premiums for policy on corporate officer where the officer's wife was the named beneficiary but she had a side agreement with the corporation that allowed it to use the proceeds to prevent insolvency if needed); and *Omaha Elevator v. Comm'r*, 6 B.T.A. 817 (1927) (policy purchased for employee's benefit but could revert to the employer).
- 17 Section 264(c).
- 18 Pub. L. No. 77-753 § 129 (1942).
- 19 Pub. L. No. 88-272 § 215 (1964). See also S. Rep. No. 88-830, reprinted in 1964-1 C.B. (pt. 2) 505, at 582 (1964).
- 20 Pub. L. No. 99-514 § 1003(a) (1986).
- 21 *Id.*
- 22 Staff of the J. Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 578 (J. Comm. Print 1987).
- 23 *Id.* at 579.
- 24 Staff of the J. Comm. on Tax'n, 104th Cong., General Explanation of Tax Legislation Enacted in the 104th Congress, at 364 (J. Comm. Print 1996).
- 25 *Id.*
- 26 Pub. L. No. 104-191 § 501 (1996).
- 27 Pub. L. No. 105-34 § 1084(b)(1) (1997).
- 28 See generally S. Rep. No. 105-33, at 186–187 (1997), reprinted in 1997-4 C.B., Vol. 4, pages 1265–1266.
- 29 Pub. L. No. 105-34 § 1084(c) (1997).
- 30 2007-2 C.B. 747.
- 31 For a discussion of the PLRs and Rev. Proc. 2007-61, see John T. Adney, Kirk Van Brunt and Michelle A. Garcia, I-COLI: The Genesis of Revenue Procedure 2007-61 and the Future of Insurer-Owned Life Insurance, *TAXING TIMES*, Vol. 4, Issue 1, at 15 (Feb. 2008).
- 32 113 T.C. 254 (1999), *aff'd* 254 F.3d 133 (11th Cir. 2001), *cert. denied*, April 15, 2002.
- 33 254 B.R. 578 (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002).
- 34 136 F.Supp.2d 762 (S.D. Ohio 2001), *aff'd* 326 F.3d 737 (6th Cir. 2003), *reh. denied*, 338 F.3d 534 (6th Cir. 2003).
- 35 250 F.Supp.2d 748 (E.D. Mich. 2003).
- 36 Lee Sheppard, "Janitor" Insurance as a Tax Shelter, *TAX NOTES* (Sept. 25, 1995), at 1526.
- 37 Michael Hiltzik, *Feds Say the O.C. Register's Ghoulish Purchase of Life Insurance on its Employees Cost it Millions*, *LOS ANGELES TIMES* (Feb. 19, 2019). The article colorfully explains that the reference to "dead peasants" has its roots in Nikolai Gogol's novel *Dead Souls*, in which a con man who crisscrosses czarist Russia buys up dead serfs as collateral for a business deal.
- 38 Pub. L. No. 109-280 § 863(a) (2006).
- 39 2009-1 C.B. 1048.
- 40 See also John T. Adney, Bryan W. Keene and Joel Mann, *Guidance Released on COLI Best Practice Rules*, *TAXING TIMES*, Vol. 5, Issue 3, at 37 (Sept. 2009).
- 41 Revenue Act of 1913, October 3, 1913, ch. 16, 38 Stat. 166, at 167.
- 42 Rev. Rul. 2009-13, 2009-1 C.B. 1029. The first conclusion of the ruling, concerning the basis of the contract that is sold, subsequently was rendered obsolete by Section 13521 of the Tax Cuts and Jobs Act, which amended Section 1016(a) to clarify no basis adjustment is required for reasonable mortality or other charges under a life insurance or annuity contract.
- 43 Rev. Rul. 2009-14, 2009-1 C.B. 1031.
- 44 John T. Adney and Craig R. Springfield, *They Go Bump in the Night: Life Insurance Policies and the Law of Material Change*, *TAXING TIMES* (May 2012, Supplement).

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REGISTRATION OPENING JULY 1.

TAM 201844009: When is a Permitted Practice not a “Permitted Practice”?

By Kristin Norberg

On Nov. 2, 2018, the Internal Revenue Service (IRS) released Technical Advice Memorandum 201844009 (the TAM). The TAM addressed the proper morbidity assumptions to be used under pre-2018 tax law to compute tax reserves for a block of long-term care (LTC) insurance contracts when the statutory reserving assumptions had been changed after the policies were issued. As will be explained in more detail in this article, the IRS concluded that the tax reserve assumptions under consideration should also be updated to follow the new statutory reserve assumptions, rather than being locked in at the issue date.

The paragraph of the Internal Revenue Code (IRC)¹ at issue in the TAM has been repealed by the 2017 tax law commonly known as the Tax Cuts and Jobs Act (TCJA),² and the regulations discussed in the TAM are effectively obsolete for tax years beginning after 2017. However, LTC insurance reserves are an area where guidance from the National Association of Insurance Commissioners (NAIC) has historically been more principle-based than specifically prescribed, and the pre-2018 tax reserve requirements for LTC insurance relied more directly on a company’s annual statement reporting than was the case for individual life insurance or annuity contracts. As a result, the TAM raises some interesting questions of ongoing relevance in a post-TCJA, principle-based reserve (PBR) environment, particularly around the identification of NAIC-prescribed methods and assumptions vs. state-specific permitted practices.

BACKGROUND: TAX RESERVE ASSUMPTIONS PRE-TCJA

For life insurance reserves computed under IRC § 807(d), which typically include active life reserves (contract reserves) held for LTC insurance, prior law required specific methods, mortality or morbidity tables, and interest rates. For mortality and morbidity assumptions, IRC § 807(d)(2)(C) required use of the prevailing commissioners’ standard tables, with appropriate adjustments, such as for substandard risks. Such tables



were defined in IRC § 807(d)(5)(A), generally, as the most recent commissioners’ standard tables prescribed by the NAIC that were permitted to be used in computing reserves for a particular type of contract under the insurance laws of at least 26 states when the contract was issued. Under a special rule in IRC § 807(d)(5)(C), if there was no prevailing table applicable to a contract when it was issued, the Secretary of the Treasury was directed to prescribe regulations for determining the applicable table.

The Treasury Department did promulgate such regulations, as Treas. Reg. § 1.807-1.³ The regulation prescribed the tables to be used for certain categories of insurance contracts or benefits that did not have a prevailing table at the time, including various group life insurance benefits and various noncancellable accident and health (A&H) insurance benefits. Pursuant to IRC § 816(e), the tables prescribed for noncancellable A&H insurance contracts would apply also for guaranteed renewable A&H insurance contracts, such as the LTC insurance contracts at issue in the TAM.

Treas. Reg. § 1.807-1(a) provided descriptions of mortality and morbidity tables potentially applicable to LTC insurance contracts (Table 1).

Table 1
Mortality and Morbidity Tables for LTC Insurance Contracts

Type of Contract	Table
9. Noncancellable A&H insurance (active life reserves); benefits issued before 1984	Tables used for NAIC annual statement reserves as of Dec. 31, 1983
12. Noncancellable A&H insurance (active life reserves); all benefits issued after 1983 other than disability and accidental death	Tables used for NAIC annual statement reserves
14. Noncancellable A&H insurance (claim reserves); all benefits other than disability for all years of issue	Tables used for annual statement reserves

Source: Treas. Reg. § 1.807-1(a).

Note that for benefits issued before 1984, the mortality and morbidity tables for active life reserves prescribed by Treas. Reg. § 1.807-1(a) line 9 were locked in based on the 1983 NAIC annual statement. For LTC insurance and other A&H insurance benefits addressed in lines 12 and 14 of the regulation, however, neither the chart nor the accompanying text specified whether the relevant tables were limited to those used for the annual statement in the year a contract was issued or in a particular specified year. This question, with respect to line 12 of the regulation, is the primary issue addressed in the TAM.

As discussed in some detail in the TAM, there have been no NAIC-prescribed tables for guaranteed renewable individual LTC insurance to date. Rather, the NAIC Health Insurance Reserves Model Regulation (the Model Regulation), as incorporated in the NAIC Accounting Practices and Procedures Manual (APPM) as Appendix A-010, provides that contracts “for which tabular morbidity standards are not specified in Exhibit 1 [of APPM Appendix A-010] shall be valued using tables established for reserve purposes by a qualified actuary.”⁴

THE FACTS OF TAM 201844009

The company in the TAM is a reinsurance company that assumes, via reinsurance and retrocession, risks under LTC insurance contracts. The company is a life insurance company for federal income tax purposes and is subject to NAIC accounting and reserving requirements, including those contained in the APPM. The company files its annual statement with its state department of insurance (DOI).

The company enters into administrative agreements under which it designs and prices policies, files policy forms and actuarial memoranda on behalf of various direct writers, and calculates statutory reserves and reports them to the direct writers. According to the TAM, the pricing and initial statutory reserving were done using the company’s “best estimate of assumptions, including the mortality rate, the morbidity rate, and the lapse rate.”

For a particular block of LTC insurance policies, the company had initially used morbidity assumptions based on government

nursing home data, adjusted to reflect experience of the parties that ceded business to the company via reinsurance or retrocession. Additionally, as later discovered in a DOI audit, the company had initially used joint life (*i.e.*, first-to-die) mortality tables on second-to-die contracts, which understated the statutory reserves.

As a result of the audit, in “Year 5” the DOI required that the company correct its reserves to use second-to-die mortality tables. To mitigate the significant increase in reserves that would result from this correction, the company requested and received permission from the DOI to update its morbidity and lapse assumptions at the same time as the mortality assumptions. The significant increase in reserves due to the mortality change and the slight increase from the lapse assumptions were partly offset by a significant decrease in reserves due to favorable morbidity experience. The changes to all three assumptions were reflected on the company’s annual statement for Year 5.

According to the TAM, the DOI viewed the change to the morbidity assumptions as being within the bounds of the Model Regulation and determined the change did not constitute a permitted practice. Specifically, in a footnote, the TAM states: “The DOI notes that the change in the morbidity assumption is not a permitted practice provided the tables and calculations still satisfy the general requirements of the prescribed accounting practice.” (As we will see, the DOI’s categorization appeared to be one of the key determining factors in the TAM’s conclusion.)

It appears that the company initially filed its tax return for the subsequent year reflecting the changes to all three assumptions as a change in basis subject to IRC § 807(f), with the 10-year spread beginning in the year after Year 5. However, the company later asserted that it should not have changed the morbidity assumptions for tax reserve purposes, but only the mortality and lapse assumptions. The question at issue in the TAM was whether the company should be allowed to continue using its original morbidity assumptions after Year 5 or if it must change the tax reserves to use the same morbidity assumptions as were used in statutory reserves.⁵

THE IRS’S ANALYSIS

The TAM’s conclusion that the company’s morbidity tables must be updated to match the tables underlying the then-current NAIC annual statement reserves was based primarily on references to the issue date found in IRC § 807(d)(5)(A) but not in IRC § 807(d)(5)(C) or Treas. Reg. § 1.807-1. As mentioned earlier, the general rule in IRC § 807(d)(5)(A) requires the use of the most recent commissioners’ standard tables permitted by at least 26 states when the contract was issued. A three-year transition period is allowed under IRC § 807(d)(5)(B) when new tables become prevailing. IRC § 807(d)(5)(C) does include two references to the issue date: first, as a threshold test to determine whether a contract is subject to subparagraph A (prevailing tables) or subparagraph C (tables defined by regulation), which depends on whether a commissioners’ standard table was applicable to the contract when it was issued; and second, to define the earliest applicable issue years and the timing of the three-year transition period in the event Treasury changes the table applicable to a contract. These two references are repeated in the regulation. However, the IRS concludes in the TAM, nothing in IRC § 807(d)(5)(C) or Treas. Reg. § 1.807-1 requires that the tables in line 12 of the regulation be locked in at issue if a company subsequently changes the tables used in determining its NAIC annual statement reserves.

To summarize the IRS’s logic in the TAM:

1. IRC § 807(d)(5)(A), defining prevailing commissioners’ standard tables based on when contracts were issued, does not apply to this situation;
2. IRC § 807(d)(5)(C) and Treas. Reg. § 1.807-1 do not provide that the morbidity tables for reserves covered by line 12 of the regulation are locked in at issue or at a particular year; and
3. the Year 5 morbidity tables were established by a qualified actuary and, as expressed in the TAM, otherwise met the requirements of the Model Regulation and were not considered by the DOI to be a permitted practice.

Therefore, the IRS concluded, the Year 5 morbidity tables were the tables referred to by line 12 of Treas. Reg. § 1.807-1(a) beginning in Year 5, and the company must use those updated statutory morbidity assumptions for tax reserves as well.

In the TAM, the IRS also expressed its understanding of a number of additional arguments the company had made for locking in the table at the issue date, dismissing each argument in turn, as follows.

One of the company’s arguments, as described in the TAM, was that the original tables the company’s actuary had developed

in accordance with the Model Regulation when the contracts were issued were, in fact, prevailing commissioners’ standard tables under IRC § 807(d)(5)(A). In response to this argument, the IRS distinguished between “commissioners’ standard tables” actually prescribed by the NAIC (such as the 1964 Commissioners’ Standard Disability Table) and company-specific tables developed by a qualified actuary in accordance with NAIC guidance (such as tables used for LTC insurance benefits), concluding that the latter do not fall within the concept of a commissioners’ standard table.⁶

The TAM notes that the company also argued that requiring it to update the morbidity tables on in-force contracts was inconsistent with other published guidance, such as Notice 2010-29, 2010-1 C.B. 547. Notice 2010-29 has to some extent been superseded by the IRS Large Business and International (LB&I) Division Directive issued in August 2018 regarding tax reserves for certain variable annuities and life insurance contracts,⁷ but it held that Actuarial Guideline (AG) 43 could not be used to determine tax reserves for variable annuity contracts issued before AG 43’s effective date. In response to this argument, the IRS distinguished between the requirement to determine the tax reserve method at the date a contract is issued and the requirement to determine mortality and morbidity tables in accordance with Treas. Reg. § 1.807-1 in the event that no prevailing commissioners’ standard tables existed when the contract was issued.

Finally, the TAM indicates that the company made various arguments to the effect that the NAIC guidance requires continued use of the morbidity assumptions the company had established at issue, and these assumptions could not be changed except by means of a state variation departing from the Model Regulation. The IRS addressed this argument by pointing out that regardless of what the NAIC method requires for mortality or morbidity assumptions for statutory reserving purposes, the tax reserves must be determined under IRC § 807(d)(5)—in this case, subparagraph C. Further, the IRS stated, the DOI did not consider the company’s updates to its morbidity tables to be a permitted practice or other departure from the Model Regulation.

CONTINUING RELEVANCE POST-TCJA

TAMs are not precedential and cannot be relied on by other taxpayers.⁸ However, the IRS’s observations and conclusions in the TAM can provide some insight into the IRS’s views, particularly with respect to the identification of NAIC-prescribed methods and assumptions. Although the prevailing tables of prior IRC § 807(d)(5) and Treas. Reg. § 1.807-1 are obsolete for tax years beginning after 2017, the principles of required consistency with NAIC accounting requirements, the role of state regulators, and deference to qualified actuaries working within actuarial standards of practice are even more important under current tax law, which places heavy reliance on statutory reserves in determining a company’s deductible reserves for income tax purposes.

In particular, it was notable that the TAM referred numerous times to the DOI's assessment of whether the company's change in morbidity assumptions constituted a permitted practice that departed from the Model Regulation. The TAM's reliance on the DOI's categorization of the reserving approach may lead companies to think carefully about how they seek authorization from their regulators for approaches to reserves that may fall into the gray area between actuarial discretion within an NAIC-prescribed method on the one hand, and divergence from the NAIC requirements (*i.e.*, a permitted practice) on the other. Given the complexity of PBR approaches and the TCJA's increased reliance on the NAIC-prescribed method and reserves reported in the annual statement, it may be more important than ever to understand where those lines should be drawn. ■

The views expressed here are the author's and do not necessarily reflect those of Symetra Life Insurance Company.

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ENDNOTES

- 1 References to the IRC are to the Internal Revenue Code of 1986, generally as amended prior to the 2017 Tax Cuts and Jobs Act (see note 2). References to "current IRC" sections include the 2017 Act's amendments.
- 2 Pub. L. No. 115-97, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," referred to herein as the 2017 Act or the TCJA.
- 3 T.D. 8278, 54 FR 52934 (Dec. 26, 1989); 55 FR 1768 (Jan. 18, 1990).
- 4 APPM (as of Mar. 2019), Appendix A-010, paragraph 49.a.i.(c).
- 5 The IRS evidently concurred that the mortality and lapse assumptions should be updated for tax purposes and that the impact of the changes would be spread under IRC § 807(f). The TAM also stated that the company had used the correct interest rates and method and had correctly applied the statutory cap.
- 6 There have also been indications in the context of life insurance contracts that a company-specific mortality table developed by an actuary to determine reserves for a particular company's contracts is not necessarily a "prevailing commissioners' standard table." For example, Notice 2008-18, 2008-1 C.B. 363 (Feb. 4, 2008), addressed issues that may arise under a PBR framework for life insurance (as well as variable annuities). At the time Notice 2008-18 was issued, there was no "net premium reserve" with prescribed assumptions such as exists under the version of PBR ultimately adopted in the NAIC Valuation Manual Section 20 (VM-20), and the "deterministic reserve" was a seriatim reserve developed using a combination of prescribed assumptions and prudent estimates, with company experience underlying the mortality assumptions. The IRS raised concerns (and indicated "some commentators have asked") about whether the mortality assumptions underlying the deterministic reserve would meet the definition of "prevailing commissioners' standard tables" and be permissible for life insurance contract qualification purposes under IRC § 7702.
- 7 See Samuel A. Mitchell and Arthur C. Schneider, LB&I Directive Provides Safe Harbor for AG43 and PBR for Pre-TCJA Years, *TAXING TIMES*, Vol. 15, Issue 1 at 20 (Feb. 2019).
- 8 IRC § 6110(k)(3).

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ACLI Update

By Mandana Parsazad and Regina Rose

On March 22, 2019, Treasury and the Internal Revenue Service (IRS) released proposed regulations implementing Sections 101(a)(3) and 6050Y (Proposed Regulations).¹ These proposed rules follow up on guidance Treasury and the IRS had issued in spring of 2018 in Notice 2018-41, which outlined reporting and definitional rules regarding information reporting of sales of life insurance contracts and modification to the rules on transfers of life insurance contracts for valuable considerations. Instructions for Forms 1099-LS and 1099-SB to allow tax reporting pursuant to Section 6050Y were published concurrently. The deadline for comments on the Proposed Regulations is set for May 9, 2019; a public hearing is scheduled for June 5, 2019.

The Proposed Regulations reflect several changes from the rules prescribed in Notice 2018-41, which demonstrate the significant time and resources that representatives of the IRS Chief Counsel and Treasury devoted to considering and discussing industry comments and concerns regarding the new substantive and reporting rules.

ACLI provided several submissions in response to Notice 2018-41 on the life insurance industry's behalf, highlighting the need for clarification that ordinary-course business transactions that do not directly involve the acquisition of life insurance contracts but rather the sale of one trade or business to another are excluded from the definition of a "Reportable Policy Sale" in Section 101(a)(3)(B). Concern that a merger with or acquisition of a business that owns life insurance policies could be inappropriately cast as an indirect reportable policy sale of policies owned by the businesses involved was one of the most important issues in need of clarification by the industry on behalf of its policyholders. The Proposed Regulations generally address industry concerns regarding mergers and acquisitions involving businesses that own life insurance policies. In particular, the preamble to the Proposed Regulations states that "an indirect acquisition of an interest in a life insurance contract occurs when a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (directly or indirectly) an interest in the life insurance contract." The proposed rules clarify that "the term 'other entity' does not include a C corporation ... unless more than 50 percent of the gross value of the assets

of the C corporation ... consists of life insurance contracts immediately before the indirect acquisition."² The proposed rules provide several other meaningful exceptions from the definition of reportable policy sale that effectively exclude most ordinary course mergers with and acquisitions of businesses that own life insurance policies.³

The ACLI also recommended that issuers be allowed to meet the obligations under Sections 6050Y(b) and (c) on or before Feb. 15, and that the instructions be updated to clarify that Form 1099-LS must be provided to the issuer by no later than Jan. 15, while also requiring the Form be provided by the later of 20 days after sale or 5 days after the rescission period. The proposed rules accepted these industry recommendations without modification. The proposed rules also accepted an industry request that the new IRS form that implements the acquirer's reporting obligation to provide a reportable policy sale statement (RPSS) under Section 6050Y(a) be sent to the issuer's administrative office that, pursuant to the insurance contract, processes transfers of ownership.

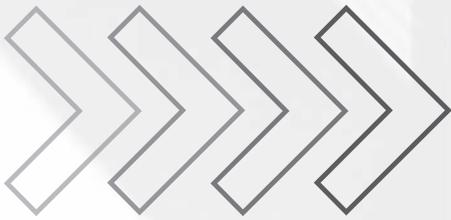
The ACLI intends to continue its dialogue with IRS Chief Counsel, Branch 4, and Treasury representatives on other details involving the reporting obligations of life insurers under the Proposed Regulations, including determining whether a transfer of ownership has occurred for purposes of Section 6050Y(b), and expects to provide a formal comment letter. ■

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

ENDNOTES

- 1 REG-103083-18, Information Reporting for Certain Life Insurance Contract Transactions and Modifications to the Transfer for Valuable Consideration Rules, *Federal Register*, <https://www.federalregister.gov/documents/2019/03/25/2019-05400/information-reporting-for-certain-life-insurance-contract-transactions-and-modifications-to-the>.
- 2 *Id.*
- 3 See Prop. Treas. § 1.101-1(c)(2).



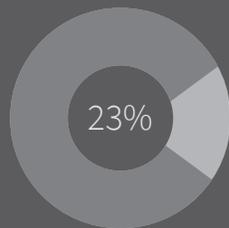
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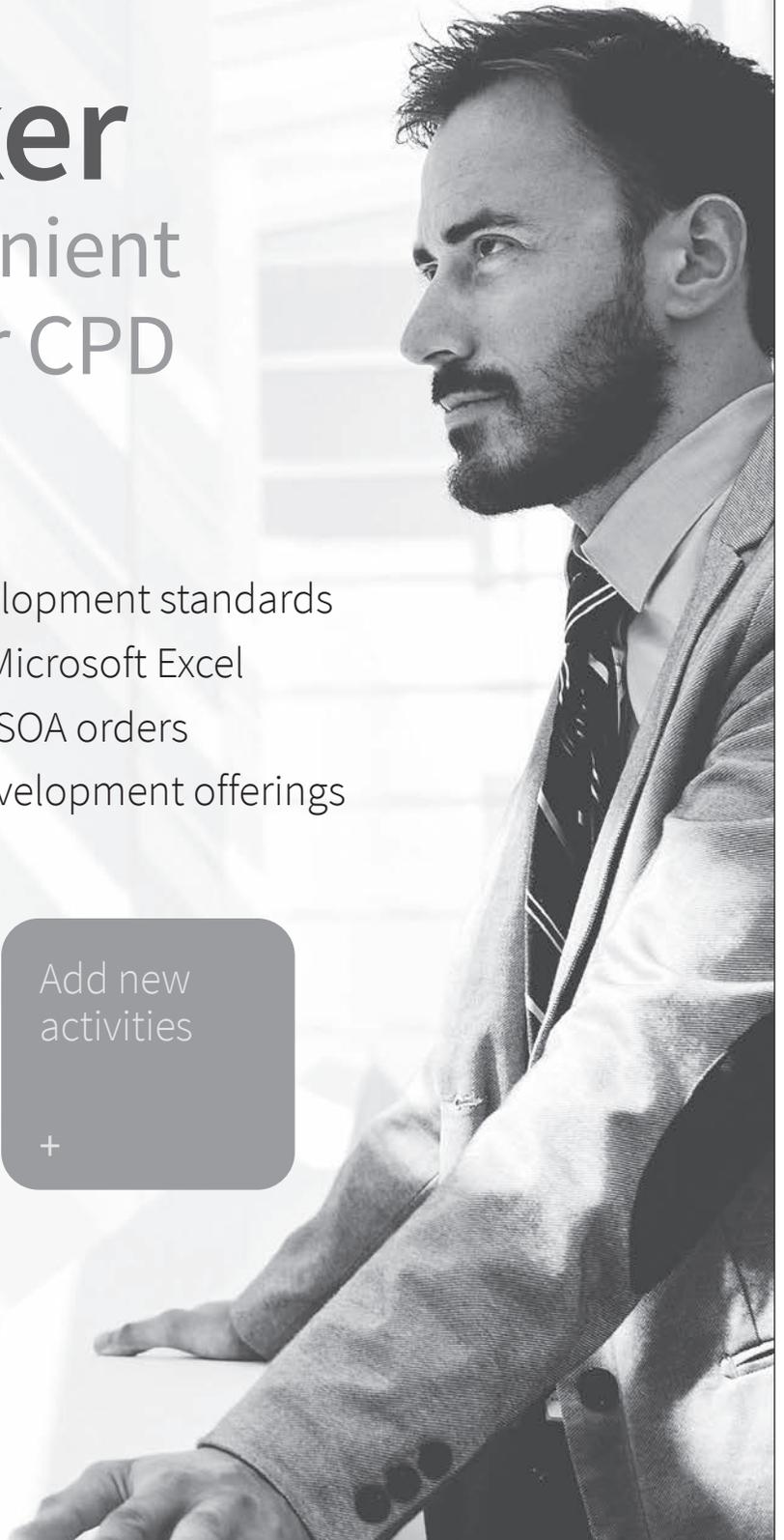
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Taxation Section Membership Survey Results

By Tony R. Litterer and Tom Edwalds

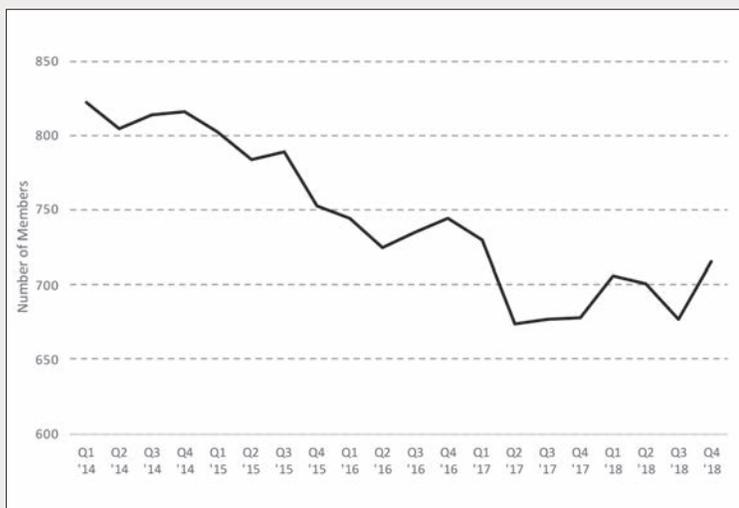
Periodically, it is important for the Society of Actuaries (SOA) sections to take the pulse of their membership to understand the value they bring to the actuarial community. In December 2018, the Taxation Section initiated a survey to understand the composition of its membership and identify where the section adds value and, more important, areas needing additional attention.

MEMBERSHIP

One of the catalysts for surveying our members is the year after year declination of the Taxation membership. Figure 1 depicts the quarterly total membership. Over the five-year period, membership decreased more than 10 percent. Prior to tax reform in 2018, membership declination was averaging 17 percent.

To better understand the change in our membership, it is helpful to recognize that the Taxation Section comprises two distinct groups of members and to consider those separately.

Figure 1
Total Taxation Section Membership Count



First we have the SOA members, who pay annual dues of \$20 as part of their SOA membership. Economically, these dues are key contributors to our section's finances. Membership among SOA members was declining until 2017 and has grown since. We attribute the recent growth to increased interest in taxation as a result of the passage of the Tax Cuts and Jobs Act (TCJA). This can be seen in both Q1 2018 and Q4 2018.

The second group includes non-SOA members, and they are usually not actuaries. They provide valuable contributions to our section such as authoring articles, speaking at various industry functions and serving on the editorial board of the section's publication, *TAXING TIMES*. In exchange for their contributions, we provide them gratis membership. In the total membership counts, however, the decline in 2017 is partly attributable to a review of these memberships. The section decreased the number of gratis members by about 35 percent, from 77 individuals to 50. The section periodically reviews gratis membership in order to manage section expenses. Gratis membership comprises about 8 percent of the total section membership.

The Taxation Section is a niche among the SOA sections, offering educational opportunities regarding company and product taxation. The increase in membership that occurred after TCJA suggests individuals are interested in tax topics and continue to see the section as a means by which to stay informed.

Many SOA sections are experiencing a decline in membership and up until TCJA the Taxation Section mirrored the trend. The section continues to seek advice from the SOA and the actuarial community at large to better understand how the section can broaden its horizon, increase membership and continue to provide value-added information efficiently.

SURVEY RESULTS

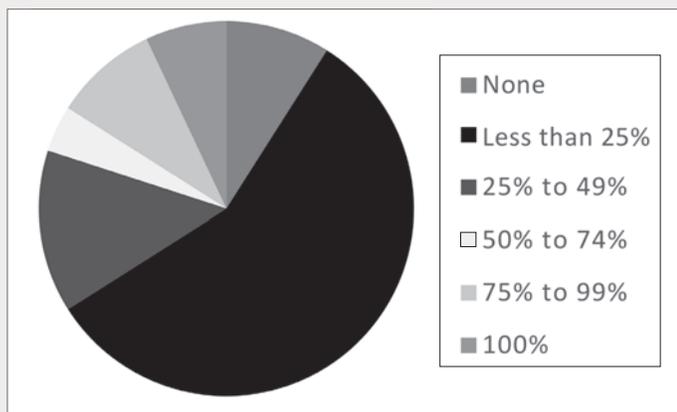
Thanks so much to those who took the time to respond to the survey. We appreciate your input and we will use the results to improve our offerings. And congratulations to the 10 winners randomly selected for responding to the survey.

The Taxation membership survey released in December 2018 was a timely opportunity to understand who is opting to be a section member and identify the value statement the section brings to the actuarial community. In total, 95 individuals responded to the survey, approximately 13 percent of total membership. This may seem like a low response rate; however, this is typical of SOA section surveys. An analysis of your responses to select questions follows.

Q1. How Much of Your Current Role is Devoted to Tax-Related Functions?

The vast majority of the respondents indicated that less than 25 percent of their responsibilities involve taxation. See Figure 2. This is not surprising, as many people take on multiple responsibilities and rarely need to devote all of their time to tax topics.

Figure 2
Tax as a Percentage of Overall Responsibility



Q2. In Two Years, How do You see Your Role Changing?

Responses to this question led us to two results. First, most respondents thought the amount of time spent on tax topics will be largely similar to what they currently do. Second, more than 10 percent of the respondents said they would most likely be retired.

In light of these results, succession planning for the next generation of actuaries spending time with taxation is something each company should address. The loss of expertise of knowledgeable tax professionals cannot be mitigated simply by asking a person to assume the role of a tax actuary. Knowledge of how and why taxation has evolved is equally important as understanding the current tax regime. Passing on this

knowledge and knowing where to acquire shared knowledge is critical to a company. One of the areas where individuals can seek advice is the Taxation Section of the SOA and the *TAXING TIMES* publication.

Q3. Overall, How Satisfied are You With Your Membership in the Tax Section?

The vast majority, over 70 percent, responded they are very satisfied with the section. The remaining responded they are somewhat satisfied. More discussion on what the section is considering to improve satisfaction will follow.

Q4. What is the Primary Reason You Joined the Tax Section?

Keeping current with changes to tax regulations and rulings was the dominant response, with over 75 percent of the vote. The primary purpose of the section is to educate and share tax knowledge with the actuarial community.

Q5. How Satisfied are You With the Following Section Resources?

Table 1 provides a glimpse of how the respondents perceive the value of different section opportunities. Seeing the highest percentage attributed to *TAXING TIMES* was a pleasant surprise. The section received some unsolicited feedback at a recent industry meeting suggesting the publication was one of the better newsletters produced by the SOA sections. This feedback may be biased. The feedback speaks volumes to the individuals intimately involved in the publication process.

On the other end of the spectrum is the low utilization of the section webpage and podcasts. We did not collect the data but this could be a generational difference between the section membership and the overall membership of the SOA. More analysis is needed to understand why utilization is low.

Table 1
Satisfaction With Tax Section Offerings

Offering	Very Satisfied	Somewhat Satisfied	Not Very Satisfied	Not At All Satisfied	Do Not Use
Section newsletter	83%	16%	0%	0%	1%
Networking opportunities	22%	38%	6%	0%	34%
Section webpage	17%	29%	3%	0%	51%
Podcasts	10%	16%	2%	0%	71%
Sessions offered at major SOA meetings	42%	42%	0%	1%	14%
Interaction with industry experts	42%	30%	2%	1%	24%



Q6. Please Indicate Your Level of Agreement With the Following Statement: “The Tax Section is a Valuable Resource for Being Aware of Current Tax Issues and Keeping Current on Changes Within the Tax Code.”

Consistent with earlier comments, *TAXING TIMES* was singled out as a very valuable resource for our members. Over 95 percent of the respondents either strongly agreed or agreed with the statement.

OTHER SURVEY QUESTIONS

The remaining questions on the survey attempted to identify areas where more information is needed or where the section can improve. The following are the key ideas shared:

- Update tax reserve textbook; some commented that it would be nice to have a combined product tax and company tax textbook.
- Provide more basic or entry-level information.
- Cover international tax laws; Canadian taxation was specifically called out.
- Address taxation as it pertains to other lines of business, such as health and property and casualty.
- Attempt greater collaboration with other sections.
- Increase the number of tax calls that discuss the pending changes or recently adopted laws, regulations or other guidance.

The tax reserve publication *Tax Basis Assets and Liabilities of U.S. Life Insurers* is a valuable resource. Individuals may want to consider purchasing it from ACTEX Publications. However, this publication, written in 2014, does not contain coverage of tax reform. As an alternative, the SOA's Regulatory Resource

(<https://www.soa.org/resources/regulatory-resource/default/>) may be the best source to identify changes to domestic and international tax. The group of individuals responsible for maintaining this website includes representation from the Taxation Section.

The section is working to increase its international coverage, and one of the first opportunities to address this will be the 2019 SOA Annual Meeting & Exhibit in Toronto, Canada. One effort is to include a comparison of product tax from the U.S.'s 7702 perspective compared to the exemption test used by our friends to the north. In addition, the section has reached out to other sections to see if they want to cosponsor sessions.

Last, the section is unique in many ways, none more important than our reliance on the expertise of non-actuaries in the legal community and the accounting community to interpret the tax code and related regulations, rulings and other guidance. The experts the section calls on to speak at various section and industry meetings share information best provided by other disciplines. As a section, we strive to identify the topics individuals need to be aware of, and when identified we work with the SOA to share the information in a timely manner. Webinars and *TAXING TIMES* are the two fastest ways to communicate information. Unfortunately, both of these take time. For webinars, there is a minimum 10-week scheduling time frame. *TAXING TIMES* requires a minimum of 11 weeks for the editorial process. For example, this article's due date was March 20 for a June publication date and this article did not require the same level of scrutiny as an article on a taxation topic. Participation in the Taxation Section as a Friend of the Section is a good way to keep informed of recent developments in the taxation of insurance.

Thank you for contributing to this article by responding to the survey. We continue to review the feedback and strive to make improvements. At any time, if we are not meeting your needs, please reach out to the section council. ■

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Rev. Proc. 2019-10: New Guidance on Changes in the Basis of Determining Life Insurance Reserves

By Sheryl B. Flum, Matthew T. Jones and Robert S. Nelson

The Tax Cuts and Jobs Act (TCJA)¹ modified the treatment of changes in the basis for determining life insurance reserves, as governed by Internal Revenue Code (I.R.C.)² § 807(f). This article summarizes the treatment of such changes in basis under prior law and describes the changes enacted by the TCJA. It further summarizes the procedures for changing the basis of computing reserves as outlined in Revenue Procedure 2019-10,³ the IRS's most recent guidance on the subject.

PRE-TCJA TREATMENT OF CHANGES IN THE BASIS OF DETERMINING LIFE INSURANCE RESERVES

Section 807(f) of the I.R.C. prescribes rules for accounting for changes in the basis for determining tax reserves. Under these rules, the impact of a change in the basis for determining life reserves for contracts issued before the year of change equals the difference between (a) the amount of the reserve as of the end of the final day of the tax year, computed on the new basis; and (b) the amount of such reserves, computed on the old basis. Prior to the TCJA, this difference (the “§ 807(f) spread”) was includible in income ratably for each of the 10 succeeding taxable years.⁴ This treatment was consistent regardless of whether the § 807(f) spread was favorable or unfavorable.

CHANGES TO I.R.C. § 807(f) UNDER THE TCJA

The TCJA did not modify the method of computing the § 807(f) spread, but it *did* alter the timing for inclusion of the corresponding

While Rev. Proc. 2019-10 does not resolve all open questions with regards to changes in basis of tax reserves pursuant to § 807(f) as amended by the TCJA, it does provide clarity for some of the key considerations.



income or deduction items by aligning it with the rules applicable to changes in method of accounting pursuant to § 481.⁵ For taxable years beginning after Dec. 31, 2017, § 807(f) spreads that are favorable to the taxpayer (*i.e.*, that decrease taxable income by strengthening tax reserves) are generally taken as a reduction of taxable income in the current tax year, while unfavorable § 807(f) spreads are generally includible in taxable income ratably over four years, also beginning in the current tax year.⁶ The inclusion of § 807(f) spreads beginning in the current tax year is a departure from prior law I.R.C. § 807(f), under which the effects of such adjustments were deferred to the following year.

The provision results in the acceleration of both favorable and unfavorable § 807(f) spreads, reducing the spread period from 10 years to one year and four years, respectively. The Joint Committee on Taxation estimated that this would increase revenues by approximately \$1.3 billion over 10 years.⁷

REV. PROC. 2019-10: NEW AND CLARIFYING GUIDANCE

On Dec. 13, 2018, the IRS released Rev. Proc. 2019-10 in order to provide procedures for an insurance company changing its basis of computing reserves pursuant to I.R.C. § 807(f), as amended by

the TCJA. To do so, the procedure modifies Rev. Proc. 2018-31⁸ to add changes in basis under I.R.C. § 807(f) to the List of Automatic Changes for which consent is automatically granted by the Commissioner of Internal Revenue.⁹

Rev. Proc. 2019-10 provides that taxpayers that modify the basis for computing life reserves must now comply with IRS procedures related to automatic method changes, including the requirement to report such method changes on Form 3115, *Application for Change in Accounting Method*. Rev. Proc. 2019-10 states that all changes in basis made during the same taxable year, for the same contract type, are considered a single change in basis. As such, the effects of all changes in basis for a particular type of contract are netted and treated as a single § 481(a) adjustment. However, it remains unclear how contract types are defined. Taxpayers will file a single Form 3115, but each change in basis by contract type must be explained within the form.

Under Rev. Proc. 2019-10, taxpayers that have been using an impermissible method and that follow applicable procedures will receive audit protection for post-2017 taxable years prior to the year of change. However, unlike some other changes in method of accounting, the revenue procedure states that a method change pursuant to I.R.C. § 807(f) does not qualify the new method for audit protection in the year of change or in any subsequent year, meaning that the IRS may force a taxpayer to change its basis for computing reserves under exam if the new method used is found to be impermissible.

Rev. Proc. 2019-10 also clarified the treatment of reserve basis changes made for taxable years ending on or before Dec. 31, 2017, for which the § 807(f) spread is still being amortized. The revenue procedure provides that any changes in reserve basis made in taxable years beginning before Jan. 1, 2018, should continue to be accounted for over the 10-year period provided by prior law I.R.C. § 807(f). In addition, when computing the transition relief amount under the TCJA's transition relief rule,¹⁰ the guidance advises taxpayers to factor any changes in reserve basis into their pre-TCJA closing reserve balance in order to avoid the duplication or omission of income as a result of such changes.

MORE TO COME?

Substantial guidance has been issued over the years to clarify whether a reserve change is a change to which § 807(f) applies. Guidance specific to changes in basis under prior law I.R.C. § 807(f) includes Revenue Ruling 94-74¹¹ and Revenue Ruling 2002-6.¹² These rulings are modified by Rev. Proc. 2019-10 to the extent that they are inconsistent with the rules applicable to changes in method of accounting.

While Rev. Proc. 2019-10 does not resolve all open questions with regards to changes in basis of tax reserves pursuant to § 807(f) as amended by the TCJA, it does provide clarity for some of the key considerations. We expect that the IRS and Treasury will provide additional guidance in the future. For example, revisions to Rev. Rul. 94-74 might be appropriate (1) to remove fact situations that are no longer applicable post-TCJA (e.g., those dealing with improper computation of the pre-TCJA “federally prescribed reserve”), (2) to add new fact situations directed at recent NAIC reserve guidance (e.g., VM-20 and VM-21), and (3) to focus the ruling more directly on what is or is not a method change, rather than on how the adjustments are taken into account. ■

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ENDNOTES

- 1 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).
- 2 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended. Unless otherwise specified, this includes the amendments made by the TCJA.
- 3 Rev. Proc. 2019-10, 2019-2 I.R.B. 296 (Dec. 13, 2018).
- 4 I.R.C. § 807[2017](f)(1).
- 5 I.R.C. § 481(a); Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (Jan. 17, 2015).
- 6 *Id.*
- 7 Joint Committee on Taxation. JCX-63-17, Estimated Revenue Effects of the “Tax Cuts and Jobs Act,” as Passed by the Senate on December 2, 2017 (Dec. 6, 2017).
- 8 Rev. Proc. 2018-31, 2018-22 I.R.B. 637 (May 9, 2018).
- 9 *Id.* Sec. 26.04.
- 10 See Note 1, Sec. 13517.
- 11 Rev. Rul. 94-74, 1994-2 C.B. 157 (Dec. 5, 1994).
- 12 Rev. Rul. 2002-6, 2002-1 C.B. 460 (Feb. 11, 2002).



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