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Determining the Value of a Life Insurance Contract: Revenue Procedure 2005-25

by Christian DesRochers

Introduction

To most observers, the value of a life insurance contract is the cash surrender value. However, when it comes to life insurance and the Internal Revenue Code, things are seldom as simple as they appear on the surface. While the answer may still be it is the cash surrender value, recent guidance tempers that response.

In April, the IRS published Revenue Procedure 2005-25, providing guidance on determining the fair market value of a life insurance contract in the context of distributions from qualified pension plans. Under section 402(a), amounts distributed to a plan participant are taxable in the year in which they are paid to the employee. Regulations provide that the cash value of any retirement income, endowment or other life insurance contract is includible in gross income at the time of the distribution.[1] Typically, individuals who receive an insurance policy as a distribution from a qualified plan use the stated cash surrender value of the policy as its fair market value for purposes of determining the amount includible in their gross income.

Regulations under section 72 indicate that the reserve accumulation in a life insurance contract constitutes the source of and approximates the amount of such cash value.[2] Moreover, the IRS has noted that the use of the cash surrender value may not be appropriate where the policy reserves represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value. In recent years, the IRS has become increasingly concerned that neither the reserve nor the cash surrender value are the correct measure of the fair market value.

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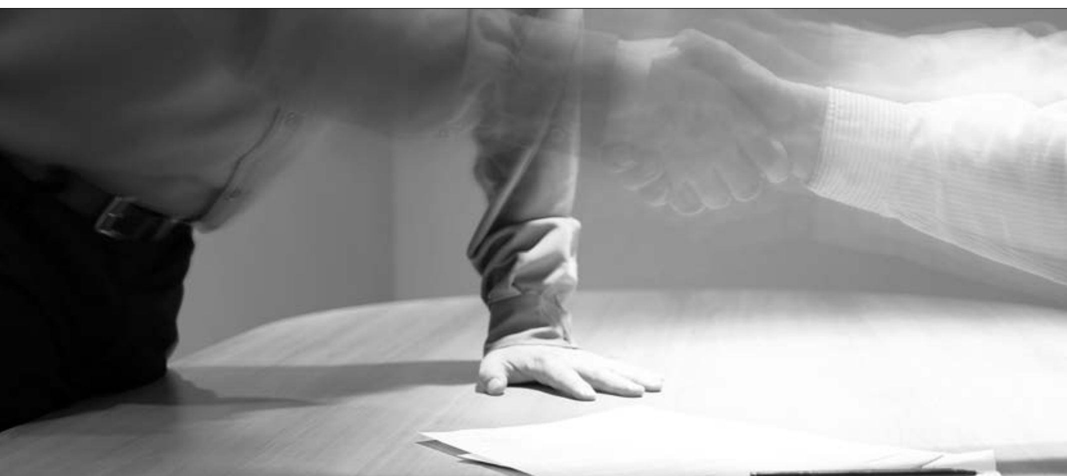
[1] Section 1.402(a)-1(a)(2).

[2] Section 1.72- 16(c)(2)(ii).



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FROM THE EDITOR

BRIAN G. KING

Our third issue of *Taxing Times* arrives just as 2005 is coming to an end. Reflecting back on this past year, I am amazed and pleased with how much the Taxation Section has accomplished. An early goal for this year was to develop and distribute our newsletter three times a year. Mission accomplished! With the help of the Society of Actuaries, we have also succeeded in conducting several surveys of our membership. In our last issue, the results from the "Role of the Tax Actuary" survey appeared, and in this issue, we offer survey results giving a profile of our membership.

In addition, our Taxation Section Web page is up and running on the Society of Actuaries Web site. This Web page offers access to valuable information about the work and research of our section. All of these accomplishments this past year have facilitated in our stated goal of promoting the exchange of insurance tax knowledge.

I thank all of you for your membership and contributions to the Taxation Section. I would also like to thank Ed Robbins, our outgoing chair, for his leadership and dedication in launching the Taxation Section. Ed's support contributed to the many accomplishments outlined above. We wish Ed the very best in his new role as president of the Society. This issue also introduces Barbara Gold in her new role as chair of our section. I am confident that her leadership will continue to move the Taxation Section on the successful path established in its maiden year.

There are some additional changes in our council members following the recent SOA elections. Art Pagnighetti, Leslie Chapman, and I have all been elected to a three-year term. We join Douglas Hertz, Peter Marion and James Reiskytl as the Taxation Section council members. While both Art and I have served as council members this past year, Leslie is a new council member. Join me in welcoming Leslie Chapman and also in saying goodbye and thanks to Donald Walker and Charles (Bud) Friedstat who are leaving the council. Also, congratulations to Bud on his election to the SOA Board of Governors.

Again, thanks to all who have worked so hard in making the Taxation Section's initial year such a huge success. Here's to continuing that tradition in 2006. We hope you enjoy the current issue of *Taxing Times*. And remember to pass on to the editor any article ideas or timely topics that you would like to see in future issues.

Sincerely,
Brian G. King
Editor

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Ask the Editor

Every Issue of ***Taxing Times*** will feature an "Ask the Editor Column." This is an opportunity for our readers to get involved with our section newsletter. We want your comments, questions and topics. Please send your e-mails to *brian_king@aon.com.*

The editorial board looks forward to responding to your questions and concerns. Thank you in advance for your contributions.

A Word from Our Outgoing Chair

by Edward L. Robbins

It has been a very exciting time for me to help launch a new section over the past year. The enthusiasm of the council and of the editorial board has been contagious, to the extent that we now have over 490 members and 60 corresponding members of the section. That is incredible growth for a recently formed section.

The reason for this "flying start" is obvious. We have filled a great void. As many of you know, there has been no U.S. tax material for life insurers on the basic examinations for years, and young people have been gaining their FSA credential with no required knowledge of what is the largest single expense of most life insurance companies. Likewise, many more senior actuaries now taking on significant roles in charting new directions in statutory valuation have recognized that there is a great need for their own learning of the potential tax effects of what they are putting together. Our dedication to education and research in this area has been the major draw for this section.

Beyond research and education, we have taken on the objective of helping to fortify the tax actuary "career path." Tax actuaries have traditionally had the reputation of saving their companies many times their salaries, and those in the know appreciate this value. There is a significant opportunity here to expand the role of the tax actuary. It requires efforts in the education area and also in the area of communication to other senior officers in insurance companies. Our survey of tax actuary roles has uncovered the fact that, in general, the company tax and policyholder tax functions have generally not utilized life insurance tax actuaries to the extent that they should.

I want to express my great satisfaction with the number of corresponding members that have been attracted to our section. Corresponding members are non-Society of Actuaries members and come primarily from the legal and accounting professions. Insurance company taxation is a multidisciplinary field, and we need each other for the respective skills we bring to the table. I want to especially appreciate the significant contribution several corresponding members have made to our *Taxing Times* newsletter.

Finally, it is with mixed feelings that I am moving on. Being a section chairperson has enabled me to help shape the future direction of the section, but it would not have been possible without a strong section council. The council is made up of acknowledged and articulate experts in the field, and they have enthusiastically taken up the charge that was put to them in this formative year. Since November 2005, the section is in the hands of a very capable incoming chairperson, and I have confidence that this momentum will continue.

A Word from Our Incoming Chair

by Barbara R. Gold

In 2004, the SOA held a 45-minute orientation session for incoming section chairs immediately prior to the Annual Meeting, and the incoming chairs at that time had stressed that much more time was needed in this regard. So in 2005, during its regularly scheduled September leadership meeting for incoming and continuing board members, the Society of Actuaries devoted an entire afternoon to a session for incoming section chairs. At these sessions (which were held from Sept. 15-16), we reviewed the importance of the sections to the SOA. We are the "grassroots" operational arms of the Society, directly meeting many of the needs of our members.

During this session we were initially asked two questions: first, why did we become chairs? I wasn't the comic who responded, "Because I was in the bathroom when the next chair was chosen" or "The hours from 1 to 2 a.m. were free." Rather, I responded that I became chair to expand the role of the actuary in the tax arena, which means, among other things, increased education of actuaries about tax matters and increased recognition by other tax professionals of the skill sets we actuaries can bring to the table.

Second, how would we measure whether we were successful? I answered that the Taxation Section would have a successful year if we increased the number of corresponding members and if the Section Council set and met some significant objectives and completed additional, relevant research projects. You might notice that these correspond pretty closely to what Ed—as outgoing chair—has commented on. That's because Ed has set an excellent example for how to run a section, in large part by bringing his vice chair into the decision-making process. This just happens to be one of the pointers the section chairs received at the September meeting. I know you'll join me in wishing Ed great success as president-elect of the SOA.

The continued success of our section depends on how active all of our members, both actuaries and corresponding members, are. So, when section council members reach out to you for ideas and for assistance completing projects, please do all you can to support their efforts. ◂

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The revenue procedures were issued in connection with proposed regulations under section 402(a) of the Code addressing the valuation of a life insurance contract distributed from a qualified retirement plan.[3] While the issue of the fair market value of a life insurance contract has been the subject of litigation and regulation over many years, Revenue Procedure 2005-25, and Revenue Procedure 2004-16, which it superseded, are the first attempts by the Service to introduce a formulaic approach to valuation.

Springing Cash Values

Revenue Procedures 2005-25 and 2004-16 are primarily intended to address the valuation of distributions from 412(i) pension plans, under which the plan assets are life insurance or annuity contracts. Of particular interest to the IRS was the springing cash value plan, a policy in which "for the first few years, the cash surrender value of the policy is much lower than the value of the premiums paid or the reserve accumulations."[4] In their news release accompanying the release of Revenue Procedure 2004-16 and the proposed regulations, the IRS noted that the "guidance targets specific abuses with section 412(i) plans."[5]

Some of the plans were marketed to sole proprietors and small business owners with the intention of distributing the life insurance policy out of the plan while the policy cash value was low. Noting that "when the policy was distributed, the policy's cash surrender value was reported as the amount of the distribution to the employee," the IRS was concerned that "participants might be seeking not to be taxed on the full value of the policy."[6] The methodology set forth in the revenue procedures is not limited to "springing cash values," nor is it limited to 412(i) plans, but broadly applies to all life insurance policies distributed from qualified plans. However, the effect of the guidance has been to eliminate the perceived abuse of valuing a life insurance policy at the cash surrender value "during the period the cash surrender value is depressed."[7]

Historical Valuation Issues

The question of whether the cash surrender value is the proper measure of the value of a life insurance policy is not a new one. More than 60 years ago, in a case involving the valuation of a gift, the United States Supreme Court said:

> "Surrender of a policy represents only one of the rights of the insured or beneficiary. The owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy on the insured's death. That these latter rights are deemed to be valuable by purchasers of insurance to have substantial value are clear from the difference between the cost of a single premium policy and the immediate or early cash surrender value."[8]

The concept that the policy reserve may be a more appropriate value than the cash surrender value appears in a tax court case,[9] as well as a Revenue Ruling 59-195, which held:

> "Where an employer purchases and pays the premiums on an insurance policy on the life of one of its employees and subsequently sells such policy, on which further premiums must be paid, to the employee, the value of the

[3] Amendments to the regulations under section 402 were proposed on Feb. 13, 2004 (REG-126967-03, 2004-10 I.R.B. 566) to clarify that the fair market value standard controls when such a contract is distributed. While proposed regulations under sections 79 and 83 clarify that the amount includible in income under those sections is based upon the fair market value of the insurance contract rather than its cash value, the proposed regulations do not provide any guidance as to what constitutes fair market value. Thus, the methodology set forth in the revenue procedures applies to determinations under those sections as well.

[4] IRM 4.72.8.5.3 Springing Cash Value Life Insurance, See also Announcement 94-101, 1994-35 I.R.B. 53.

[5] Treasury and IRS Shut Down Abusive Life Insurance Policies in Retirement Plans IR-2004-21 Feb.13, 2004.

[6] IRM 4.72.8.5.3.

[7] IR-2004-21.

[8] *Guggenheim v. Rasquin*, 312 US 254 (February 3, 1941).

[9] *Charles Cutler Parsons v. Commissioner*, 16 T.C. 256 (January 31, 1951).

policy, for computing taxable gain to the employee in the year of purchase, is its interpolated terminal reserve value at the date of the sale, plus the proportionate part of any premium paid by the employer prior to the date of the sale which is applicable to a period subsequent to the date of the sale."[10]

> ... the IRS noted that "the life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy ...

Under section 807, in determining the taxable income of a life insurance company, the allowable reserve deduction is the greater of the net surrender value of the contract or the tax reserve, where the net surrender value is the cash value reduced by any surrender charge. The relationship between the cash surrender value and the federally prescribed reserve was applied in a different context in Notice 89-25,[11] posing the question of the amount "included in a plan participant's gross income when the participant receives a distribution from a qualified plan, that includes a policy issued by an insurance company, with a value substantially higher than the cash surrender value stated in the policy."

In response, the IRS noted that "the life insurance reserves (if any) computed under section 807(d), together with any reserves for advance premiums, dividend accumulations, etc., represent a much more accurate approximation of the fair market value of the policy than does the policy's stated cash surrender value."[12]

In its recent discussion of the proposed regulations under section 402(a), the Service commented that since Notice 89-25 was issued, life insurance contracts have been structured in a way that, for some period, neither the reserves nor the cash surrender value represent the fair market value of the contract, citing the example of a contract with a large surrender charge or other charges which are expected to be eliminated or reversed in the future. The IRS was conerned that if the contract is distributed prior to the elimination or reversal of those charges, both the cash surrender value and the reserve under the contract could significantly understate the fair market value of the contract, concluding that it would not be appropriate to use either the net surrender value (i.e., the contract's cash value after reduction for any surrender charges) or, because of the unusual nature of the contract, the contract's reserves to determine the fair market value of the contract.[13]

Revenue Procedure 2004-16[14]

In sympathy to the "many taxpayers [who] could have difficulty determining the fair market value of an insurance contract" in light of the IRS's comments that "Notice 89-25 should not be interpreted to provide that a contract's reserves are always an accurate representation of the contract's fair market value," the revenue procedure provides interim rules under which the cash value (without reduction for surrender charges) of a life insurance contract distributed from a qualified plan may be treated as the fair market value of that contract.

For a contract which is not a variable contract, the cash value (without reduction for surrender charges) may be treated as the fair market value of a contract as of a determination date, provided such cash value is at least as large as the aggregate of:

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[10] Rev. Ruling 59-195, 1959-1 C.B. 18.

[11] Notice 89-25, 1989-1 C.B. 662.

[12] Notice 89-25, 1989-1 C.B. 622, Question 10.

[13] REG-126967-03, 2/17/04.

[14] I.R.B. 2004-10.

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- The premiums paid from the date of issue through the date of determination, plus
- Any amounts credited (or otherwise made available) to the policyholder with respect to those premiums, including interest, dividends and similar income items (whether under the contract or otherwise), minus
- Reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

For a variable contract, (as defined in section 817(d)) cash value (without reduction for surrender charges) may be treated as the fair market value of the contract provided such cash value is at least as large as the aggregate of:

- The premiums paid from the date of issue through the date of determination, plus
- All adjustments made with respect to those premiums during that period (whether under the contract or otherwise) that reflect investment return and the current market value of segregated asset accounts, minus
- Reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the date of determination and are expected to be paid.

Revenue Procedure 2004-16 was effective on Feb. 13, 2004.

Revenue Procedure 2005-25[15]

To show that no good deed goes unpunished, the IRS received comments that the formulas in Rev. Proc. 2004-16 did not work well for certain types of traditional life insurance policies. Among the concerns raised were the potential for double-counting of policyholder dividends, the lack of adjustment for surrender charges and the non-recognition of withdrawals or distributions in the formulas. This led to the issuance of Revenue Procedure 2005-25, which supersedes Revenue Procedure 2004-16. It introduces the concept of a PERC amount, and provides an anti-abuse provision, warning that “the formulas set forth in . . . this revenue procedure must be interpreted in a reasonable manner, consistent with the purpose of identifying the fair market value of a contract.”

The safe harbor for non-variable contracts defines that the fair market value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of:

- The sum of the interpolated terminal reserve and any unearned premiums plus a *pro rata* portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the PERC amount and the applicable Average Surrender Factor.

The PERC amount is the aggregate of:

1. The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus
2. Dividends applied to purchase paid-up insurance prior to the valuation date, plus
3. Any amounts credited (or otherwise made available) to the policyholder with respect to premiums, including interest and similar income items (whether credited or made available under the contract or to some other account), but not including dividends used to offset premiums and dividends used to purchase paid up insurance, minus
4. Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date, minus
5. Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

[15] I.R.B. 2005-17.

For variable contracts, the fair market value may be measured as the greater of:

- The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, and
- The product of the variable PERC amount and the applicable Average Surrender Factor.

A surrender charge is permitted to be taken into account only if it is contractually specified at issuance and expressed in the form of nonincreasing percentages or amounts.

The variable PERC amount is the aggregate of:

1. The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums, plus
2. Dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date, plus or minus
3. All adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts, minus
4. Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated or otherwise reversed at a later date, minus
5. Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

The Average Surrender Factor for purposes of sections 79, 83 and 402(b) (for which no adjustment for potential surrender charges is permitted) is 1.00. In the case of a distribution or sale from a qualified plan, if the contract provides for explicit surrender charges, the Average Surrender Factor is the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the applicable surrender factor for a policy year is equal to the greater of:

- 0.70, and
- A fraction, the numerator of which is the projected amount of cash that would be available if the policy were surrendered on the first day of the policy year (or, in the case of the policy year of the distribution or sale, the amount of cash that was actually available on the first day of that policy year) and the denominator of which is the projected (or actual) PERC amount as of that same date.

The applicable surrender factor for a year in which there is no surrender charge is 1.00. A surrender charge is permitted to be taken into account only if it is contractually specified at issuance and expressed in the form of nonincreasing percentages or amounts.

The revenue procedure clarifies that dividends held on deposit with respect to an insurance contract are not included in the fair market value of the contract. However, such dividends are taxable income to the employee or service provider at the time the rights to those dividends are transferred to that individual. It also addresses the treatment of policy loans, noting that, if a loan (including a loan secured by the cash value of a life insurance contract) is made to an employee to the extent the debt is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee or service provider at that time.

Revenue Procedure 2005-25 applies to distributions, sales and other transfers made on or after Feb. 13, 2004. However, for periods before May 1, 2005, taxpayers may rely on the safe harbors of this revenue procedure and for periods on or after Feb. 13, 2004, and before May 1, 2005, taxpayers may also rely on the safe harbors in Revenue Procedure 2004-16. ◀

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T³: *Taxing Times* Tidbits

What to do About Tax Reserve Estimates

by Peter H. Winslow

We frequently are asked what to do when a company has reported aggregate estimates of tax reserves on the tax return, instead of tax reserves computed precisely according to the requirements of the Internal Revenue Code, and the IRS has challenged the reserve deduction. Companies faced with this problem usually are aware that reserve estimates are technically not permitted because life insurance reserves must be computed on a seriatim basis. Under I.R.C. § 807(d), tax reserves for life insurance or annuity contracts are required to be computed in accordance with Commissioner's Reserve Valuation Method (CRVM) or Commissioner's Annuity Reserve Valuation Method (CARVM), which is defined by the NAIC in the Standard Valuation Law in terms of the characteristics of a particular contract (e.g., benefits, premiums, issue date). Moreover, after the CRVM or CARVM is computed using the federally prescribed interest rate and mortality table, the reserve is compared to the statutory reserve and the net surrender value on a contract-by-contract basis. Despite these requirements, the ideal of the Internal Revenue Code is not always matched by reality and, due to time or data constraints, tax reserve estimates find their way into the tax return. When this compliance failure is discovered on audit, the IRS examiner typically disallows the year-end reserves (or any amount in excess of the net surrender values that can be established).

There are several potential ways to respond to the IRS in this audit situation, depending on whether the corrected reserves are greater or smaller than the estimate reported. The first step is to make sure that the IRS examiner treats the reserve disallowance as reserve weakening subject to I.R.C. § 807(f). Application of the reserve weakening rules has the dual benefit of deferring for one year any reduction in reserves for the contracts issued before the taxable year, and spreading the reserve decrease ratably over 10 years. The economic impact of the 10-year spread rule can be dramatic. In fact, for lines of business with high lapse rates, a reserve decrease coupled with a 10-year spread actually may be beneficial. A beneficial result is not unusual in these circumstances because tax reserve estimates most often occur in small specialty lines that are in a run-off status. Thus, a company may not want to argue with the reserve disallowance at all. If this fortuitous situation is not present, the position a company will want to take will depend on the answers to the following questions:

1. Is it possible to now compute precise tax reserves on a seriatim basis?

2. Is it possible to prove actuarially to the IRS examiner that properly computed tax reserves in excess of the net surrender value would be allowable if the exact computations were to be made?

3. If the answer to 1 and/or 2 is "yes," will the resulting tax reserves be greater or smaller than the reserves reported on the original tax return?

4. If correctly computed tax reserves would be greater, what is the first open year in which recomputations can be made?

5. If the answer to 3 is "greater," would an increase in reserves subject to I.R.C. § 807(f) in the first open year be better or worse than no change (i.e., how quickly do the reserves run off)?

Assuming correct tax reserves can be computed and would be greater, the change would be beneficial despite application of the 10-year spread rule of I.R.C. § 807(f). In this situation, the company probably should go through the effort of responding to the IRS examiner with properly computed reserves, and consideration should be given to filing claims for refund for prior years starting in the earliest open year under the authority of Rev. Rul. 94-74, 1994-2 C.B. 157. Corrections for prior years not only may result in refunds of tax, but they also can have the beneficial effect of reducing the adverse impact of the 10-year spread.

This strategy of filing refund claims for prior years also is advisable even if the company would prefer that the IRS not make an adjustment to increase reserves, either because it is too much work to actually compute the

correct reserves or because an increase in reserves is not beneficial due to the 10-year spread. Most IRS examiners and appeals officers are willing to concede proposed adjustments that appear to be beneficial in the current year (even if they may have adverse tax consequences in future years). This is particularly true where consistent treatment of the reserve item would result in refunds for prior open years. In such circumstances, it may be possible to negotiate a favorable resolution with the IRS examiner or appeals officer, without computing the exact reserves merely by proving that the reserves will likely increase and result in refunds for earlier years.

What should be avoided is a compromise that results in a reserve disallowance followed by a correction increasing reserves in a subsequent year with the increase subject to a 10- year spread.

The more difficult situation to deal with is when it is too difficult or too costly to compute exact tax reserves, and the company cannot demonstrate to the IRS' satisfaction that the proper reserves would be equal to or greater than the reported tax reserves. In these situations, creative solutions should be proposed that have as their ultimate outcome a transition to correctly computed reserves at a reasonable tax cost. For example, consideration could be given to computing exact tax reserves for the current year and seeking a compromise with the IRS whereby allowable tax reserves in interim years will be determined by grading to the correct amount. What should be avoided is a compromise that results in a reserve disallowance followed by a correction increasing reserves in a subsequent year with the increase subject to a 10-year spread.

Valuation of Insurance In Force for Tax Purposes

by Peter H. Winslow and Samuel A. Mitchell

Where an election is made under I.R.C. § 338 to treat an acquisition of the stock of an insurance company as an asset acquisition, Prop. Treas. Reg. § 1.338-11 provides that the deemed asset sale and purchase shall be treated as if it occurred by assumption reinsurance for tax purposes. To determine the gain on the ceding company's deemed sale and the tax basis to the deemed reinsurer, allocation of the total purchase price to particular assets requires a determination of the fair market values of the assets. For purposes of determining the portion of the total consideration allocable to the insurance in force, Prop. Treas. Reg. § 1.338-11(b)(2) has a special rule that provides that fair market value "is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts."

It is unclear what this means and how it would effect, if at all, an actuarial appraisal of insurance in force. It is possible that reference to tax reserves in the proposed regulations could go to the very heart of the assumptions that are made by the actuary. To appreciate this, it may be useful to describe some of the basic principles of an actuarial appraisal that set this type of appraisal apart from valuation techniques generally applied to intangible assets in other industries.

When appraisers in other business contexts use an income approach to value income-producing contractual rights, they typically look to anticipated future cash flows that they assume will be generated from ownership of the intangible asset, and then apply a discount rate to determine the asset's present value. An actuarial appraisal uses the same general income approach to valuation of insurance in force, but with a major variation—it uses distributable earnings based on statutory accounting for the assumed future income stream, instead of future cash flows. The reasoning behind the variation for an actuarial appraisal is that the use of cash flows would misstate true economic value to a purchaser because the cash cannot be distributed to the owners until profits emerge under statutory accounting principles.

The use of distributable earnings in an actuarial appraisal not only has the effect of deferring earnings, but also can have the effect of converting what ordinarily would be considered a liability into an asset. This can be illustrated by how the insurance industry views a paid-up life insurance contract. Most general business appraisers would assume that a paid-up contract is a liability, not an asset. After all, there is no future positive cash flow in the form of premiums that will be generated by the contract. However, an actuarial appraiser would assume that the premiums have not yet been earned on the contract and, in effect, will be received by the company in the future as the reserves are released. Stated differently, an actuarial appraiser assumes that assets equal to the reserves belong to the policyholders, not the company. Therefore, the actuarial appraiser's valuation assumes that assets equal to the statutory reserves will be transferred in the sale of a block of business. For this reason,

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the use of statutory accounting and distributable earnings in an actuarial appraisal converts an economic liability into a valuable intangible asset from which future earnings will be generated.

Getting back to the proposed regulations, what does it mean when it says that tax reserves should be used instead of statutory reserves to determine the ceding commission transferred to the reinsurer? Is the actuary supposed to perform an ordinary actuarial appraisal using statutory distributable earnings to determine future income, and then increase that value by the difference between statutory and tax reserves based upon the proposed regulations' apparent assumption that the reinsurer would be willing to accept a smaller gross reinsurance premium (i.e., the perceived value to the reinsurer is greater)? This literal application of the proposed regulations seems to have the opposite result of what may have been intended because, in an actual assumption reinsurance transaction, the ceding commission (i.e., the purchase price) for tax purposes is usually determined by the difference between the fair market value of the assets transferred and the amount of tax reserves. That is, the deemed value of the insurance in force as measured by the ceding commission is smaller for tax purposes as a result of using tax reserves as the measure of the ceding commission. Another possible interpretation of the proposed regulations is that "fair market value" should be determined by adjusting future distributable earnings used in the appraisal by assuming that tax reserves, rather than statutory reserves, are required to be held. Under either interpretation of the proposed regulations, the "fair market value" of insurance in force may be different from what the parties to the stock transaction actually assumed in their negotiations and also different from true fair market value. For this reason, in a letter to the IRS dated Aug. 28, 2002, the American Council of Life Insurers recommended that this special definition of fair market value be eliminated from the final regulations.

Estates of Employees Covered by COLI Plans May be Entitled to the Death Benefits Paid to the Employers, But the IRS Says They Are Not Entitled to a Tax Exclusion for the Benefits

by Peter H. Winslow and Susan J. Hotine

The IRS attacked employers' deductions for broad-based corporate-owned life insurance (COLI) plans (or "janitor insurance"), arguing that the policy loans, the interest payments and sometimes even the insurance itself are economic shams. At the same time, the estates of rank-and-file employees covered by these plans have sought to recoup the death benefits paid to employers, claiming that the employers did not have an insurable interest in the lives of the employees because the employers' economic interest in the continued life of the employees was not substantial. In these circumstances, the laws of many states provide that, while insurers still have contractual obligations to pay death proceeds, the estates of the covered employees in whose lives the employer had no insurable interest have a cause of action to recover those proceeds. Although the death proceeds were paid to the employers, courts have recognized the legal claims of the employees' estates against employers for such proceeds, or have recognized a constructive trust for such proceeds in favor of the employees' estates.[1]

While courts seem to be saying that the employees' estates are the proper recipients of the COLI death proceeds for rank-and-file employees, the IRS has concluded that the amounts so received are not death proceeds, or at least not "amounts received . . . under a life insurance contract, . . . paid by reason of the death of the insured" for purposes of the tax exclusion under I.R.C. § 101(a). In PLR 200528023 (July 15, 2005), the IRS considered facts involving a class action settlement of claims filed on behalf of former employees who died while covered by the employer's COLI policies, similar to the facts of the *Mayo v. Hartford Life Ins. Co. and Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.* cases. The facts of the PLR state that initially an employee's estate brought suit against the employer, claiming that the employer did not have an insurable interest in the life of the employee and, therefore, was not the rightful beneficiary for the policy on his life. The employee's estate then requested certification of a class of similarly situated employees. In the course of the litigation, the parties settled and the funds paid by the employer were put into a trust for the settlement class. Each qualified former employee's estate or heir received a proportionate amount of the settlement fund determined on the basis the face amount of each policy. The employee's estate apparently argued that under the origin of the claim doctrine, the proceeds distributed from the settlement class trust were excludable from income pursuant to I.R.C. § 101(a) because the proceeds retained their character as insurance proceeds paid by reason of death on the insured persons.

[1] See *Mayo v. Hartford Life Ins. Co.*, 354 F.3d 400 (5th Cir. 2004); *Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.*, 408 F.3d 1300 (10th Cir. 2005).

The IRS noted that the court had held that the contracts between the insurer and the employer were valid, even though the employer lacked an insurable interest. Under such circumstances, the proceeds received by the employer upon the deaths of the covered employees were proceeds paid by reason of death of the insured. The IRS then noted that the court's decision permitted the estates to sue for monies improperly converted by another party, saying that the estates' recovery was for funds that were converted by the employer. The IRS concluded that, because the amounts recovered by the estates were pursuant to a settlement of the claims raised in the litigation to recover converted funds, the amounts distributed from the settlement class trust were not insurance proceeds paid by reason of death.

Because the court found the COLI contracts to be valid, the IRS concluded that the named beneficiary was the only person entitled to received the proceeds paid by reason of death.

The PLR's analysis focuses on the fact that the court found the COLI contract to be valid, even though the employer had no insurable interest, but fails to consider the consequences of the state-law finding that the employer had no insurable interest. Certainly, in a situation where state law imposes a constructive trust on the employer for the proceeds, the implication is that the proceeds do not belong to the employer, or more specifically, that the employer was not the proper beneficiary of the policies. Even the cause of action to recover "converted funds" implies that the employer converted, for its own use, funds that did not belong to it. The PLR does not really address the estates' argument that, under state law, the estates (and not the employer) are the proper beneficiaries of the COLI contracts covering employees in whom the employer had no insurable interest. Because the court found the COLI contracts to be valid, the IRS concluded that the named beneficiary was the only person entitled to received the proceeds paid by reason of death. Finding that the contracts were valid certainly means that the insurer is contractually required to pay out the proceeds. However, a finding that the employer has no insurable interest effectively may mean, under state law, that the employer is not a proper beneficiary of those proceeds, and that, as a necessary consequence, someone other than the employer must be the proper beneficiary. If the estates had sued the employer and raised the insurable interest question prior to the death proceeds being paid out, and if the court had ordered the insurer to pay the proceeds directly to the employees' estates, it is unlikely that the IRS would have arrived at the same conclusion that the death benefits were not paid by reason of the death of the insureds. Similarly, then, any amounts paid to the estates in settlement of their claims to the death proceeds—that is, in lieu of the death proceeds—paid by the insurer probably should be tax-exempt under I.R.C. § 101.

We can speculate why the IRS concluded as it did. The IRS may have been concerned that the employer had long ago excluded the death proceeds from its income under I.R.C. § 101 and a second exclusion for the employees' estates would be inappropriate because the employer now may have an argument for a deduction for the settlement payments. However, there are a number of theories the IRS could have used to deny a tax benefit to the employer, rather than choose to deny the I.R.C. § 101(a) exclusion to the employees' estates. For example, the IRS could have argued that either no deduction is allowable because the death proceeds never belonged to the employer and, if they did, the deduction is disallowed under I.R.C. § 265(a) as allocable to tax-exempt income. Denial of a tax benefit to the employer, coupled with an income exclusion to the employee for the death benefits, would put all parties where they should be under I.R.C. § 101.[2] ◂

[2] See *Nahey v. Commissioner*, 196 F.3d 866 (7th Cir. 1999).

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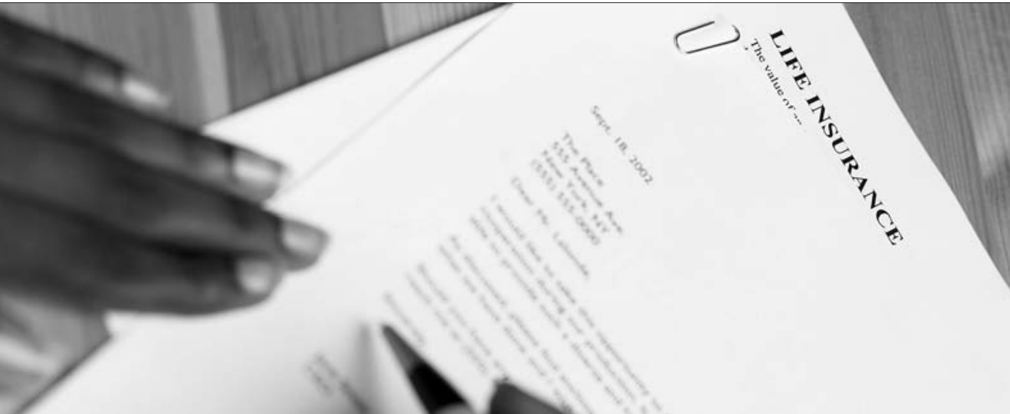
Determining Guideline Premiums for Fixed-Premium Universal Life Insurance Contracts

by John T. Adney, Brian G. King and Craig R. Springfield



Over the past few years, the Internal Revenue Service has issued two private letter rulings waiving the failure of certain fixed-premium universal life insurance (FPUL) contracts to satisfy the guideline premium test (GPT) under section 7702 of the Internal Revenue Code [*see* PLR 200328027 (Apr. 10, 2003) and PLR 200230037 (Apr. 30, 2002)]. More specifically, the IRS concluded that the errors that caused such contracts to fail were reasonable errors, which is part of the standard that must be satisfied in order for errors to be waivable under section 7702(f)(8).

FPUL contracts, sometimes called interest-sensitive whole life contracts, are hybrid contracts, combining features of both universal life insurance and whole life insurance. Similar to whole life insurance, FPUL contracts require the payment of fixed premiums and provide guaranteed minimum cash values (or tabular cash values) based on Standard Nonforfeiture Law (SNFL) requirements. In addition, these types of contracts provide for a universal life insurance type accumulation account, which reflects current assumptions for interest, mortality and expenses. The cash value structure of this type of contract design creates what has been referred to as a dual or secondary cash value guarantee, whereby the contract cash-value is based on the greater of the accumulation account value or the tabular cash value.

Life insurance contracts can satisfy the requirements of section 7702, so that the contracts are considered as life insurance for federal tax purposes–by satisfying either (a) the GPT and cash value corridor, or (b) the cash value accumulation test (CVAT). Because of the existence of dual cash surrender values, each of which typically is subject to its own set of guarantees, the treatment of FPUL contracts under section 7702 can be complicated. Section 7702 generally requires that guideline premiums be based on the interest rate(s), mortality rate(s) and expenses specified in the contract. In addition, for those contracts issued after Oct. 21, 1988, there are further restrictions on the allowable mortality and expense assumptions, both of which must be "reasonable" according to standards set forth in section 7702(c)(3)(B)(i) and (ii).

On a guaranteed basis, the accumulation account value and the tabular cash value are generally derived using different assumptions for interest, mortality and expense. The complexity of the cash value structure under FPUL contracts, particularly as it relates to the determination of the interest and expenses that must be reflected in guideline premiums, appears to have been the root of the problem that resulted in the inadvertent failure of FPUL contracts under section 7702 in the waiver rulings previously cited. This article explores the derivation of guideline premiums for a FPUL product with level annual premiums, focusing particularly on the derivation of assumptions used in the determination of guideline premiums.

Treatment of secondary guarantees in calculating guideline premiums. As FPUL plans generally have fixed annual premiums, it is important that the guideline level premium (GLP) for a given policy be no less than the corresponding gross annual premium. To calculate the GLP, a determination first must be made as to the rate or rates guaranteed on issuance of the contract with respect to interest, mortality and expenses. Because of the dual cash value guarantees, should one look to the accumulation account guarantees, the tabular cash value guarantees, or some combination of the two? The Joint Committee on Taxation's General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the DEFRA Bluebook)[1] provides guidance, saying

[1] Staff of the J. Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 649 (Comm. Print 1984).

in particular that so-called secondary guarantees must be taken into account in calculating guideline premiums:

> "Also, if the contract's nonforfeiture values for any duration are determined by a formula that uses the highest value produced by alternative combinations of guaranteed interest rate or rates and specified mortality (and other) charges, the combination of such factors used, on a guaranteed basis, in the highest cash surrender value for such duration should be used for such duration in determining either the net single premium or the guideline premium limitation."

Significantly, the DEFRA Bluebook then expands upon this comment in footnote 53 (FN 53), which is appended to the text just quoted:

> "For example, under a so-called fixed premium universal life contract, if the cash surrender value on a guaranteed basis (ignoring nonguaranteed factors, such as excess interest) is not determined by the guaranteed interest rate and the specified mortality and expense charges used to determine the policy value for some duration, but is instead determined by a secondary guarantee using the guaranteed interest rate and specified mortality and expense charges associated with an alternate state law minimum nonforfeiture value for such duration, the guaranteed interest rate and the mortality and expense charges for the secondary guarantee are to be used with respect to such duration in determining either the net single premium or the guideline premium limitation."

By following the FN 53 approach, it appears possible to design a FPUL contract so that, by its terms, it complies with the GPT. In this regard, such a contract is able to comply with section 7702 in a manner similar to that of life insurance contracts that are designed to comply with the CVAT. In reality, even under this FN 53 approach, it still is generally necessary to monitor premiums because of the possibility that premiums received and credited to the accumulation account value before an anniversary may cause "premiums paid" to exceed the sum of guideline level premiums then applicable. The fact that such premium would be permitted, if paid on the upcoming anniversary, does not prevent the early premium from causing the contract to fail under the GPT.

In order to apply the FN 53 logic to the calculation of a guideline premium, the guaranteed accumulation account value resulting from the payment of the gross premium must be projected based on the guarantees applicable to such accumulation account value. Such guaranteed accumulation account values then must be compared with the contract's guaranteed tabular values on a duration-by-duration basis. Typically, based on this comparison at the issuance of a contract, the accumulation account values will be prevailing for some initial period of time, and the tabular values will become the prevailing cash value at some point (the cross-over point) and thereafter until the contract's maturity date. In this circumstance, the contract guarantees relating to interest, mortality and expenses pertinent to the prevailing cash value form the basis for determining the appropriate actuarial assumptions to use in the determination of guideline premiums under the FN 53 methodology. Thus, in calculating the guideline premiums at issue in the typical case, it is necessary to take into account guarantees applicable to the accumulation account value for those durations when the accumulation account value is prevailing on the guarantees, and it is necessary to take into account the guarantees applicable to the tabular value for those durations after the cross-over point when the tabular value is prevailing on the guarantees. (If, on the other hand, the contract premiums were set at a level that matured the contract and provided a guaranteed accumulation account value that was the prevailing cash value for all durations, the tabular values would be irrelevant to the calculation of guideline premiums.)

If, on the other hand, the contract premiums were set at a level that matured the contract and provided a guaranteed accumulation account value that was the prevailing cash value for all durations, the tabular values would be irrelevant to the calculation of guideline premiums.

Identification of the appropriate guarantees is at the heart of the FN 53 process. This process can best be illustrated by way of examples.

Example 1: Universal Life Contract Design
The first example focuses on the derivation of the GLP for a universal life (UL) insurance contract. The sample contract underlying Example 1 is later modified in Examples 2 and 3, changing the form of the contract to a FPUL design, i.e., with a fixed annual premium and a secondary cash value guarantee in the form of tabular cash values.

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Sample Policy Characteristics:

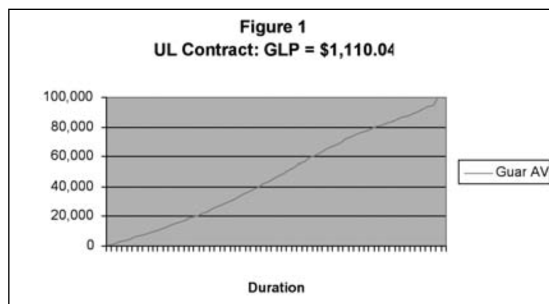
Insured:	35 year old female
Face Amount:	$100,000
DBO:	Level

Accumulation Account Value Guarantees:

Mortality:	1980 CSO ALB Female
Interest:	4% all years
Expense:	$60 annual administrative fee

Basic Actuarial Principles. Using basic actuarial principles, the GLP for a UL contract can be determined by dividing the sum of the present value of future benefits and expenses (PVFB and PVFE) by a life annuity, where all calculations are based on the accumulation account value guarantees. This results in a GLP of $1,110.04.

Projection-Based Methodology. A similar result could be obtained by solving for the level annual premium that would endow the contract for its face amount, assuming successive cash values were projected using a 4 percent interest rate, 1980 CSO mortality and the assessment of a $60 expense charge each year. The resulting cash value scale under the projection-based approach is illustrated in Figure 1.



As expected, the calculation of the GLP under both the projection method and the basic actuarial principles approach produces the same result.

Example 2: FPUL Contract
(Fixed Annual Premium = $1,000)

If the form of our contract changes from UL to FPUL, there are several changes that must be reflected in the determination of guideline premiums to account for the fact that the contract requires the payment of a fixed annual premium and provides a secondary cash value guarantee in the form of tabular cash values, as required by the SNFL for fixed premium contracts. In this example, the fixed annual premium is $1,000 per year and the tabular cash values are based on the following assumptions:

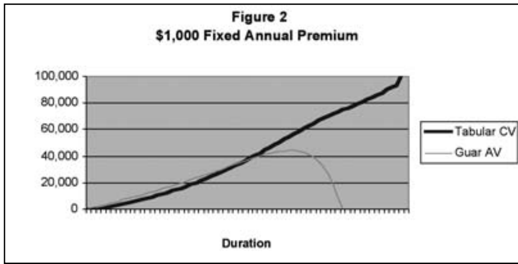
Tabular Cash Value Assumptions

SNFL Mortality	1980 CSO ALB Female
SNFL Interest	6% all years
SNFL Adjusted Premium	$860.31
SNFL Annual Expense	$139.69 (excess of $1,000 over SNFL Adjusted Premium)[2]

Application of the FN 53 process. As discussed above, where contracts have both an accumulation account value and a secondary guarantee in the form of tabular cash values, FN 53 requires that secondary guarantees be considered in selecting the appropriate policy guarantees of interest, mortality and expense that are recognized in the determination of values under section 7702. This process requires a projection of both the guaranteed accumulation account value and the tabular cash values. The assumptions with respect to interest, mortality and expense charges (applying the restrictions of section 7702 applicable to these assumptions, such as the reasonable expense charge rule of section 7702(c)(3)(B)(ii)) pertaining to the prevailing cash value as determined for each duration then need to be reflected in the calculation of guideline premiums under section 7702. Figure 2 on page 15 illustrates the projection of both the guaranteed accumulation account value and the tabular cash values.

Figure 2 typifies the result of most FPUL designs in that the accumulation account dominates at the start, but, by design, cannot mature the contract on its guarantees. The tabular cash values eventually prevail and mature the contract on a guaranteed basis. Since the contract guarantees continuation of coverage as long as the fixed premiums are paid, the reduction of the fixed premium below the amount necessary to mature the contract under accumulation account guarantees (e.g., the premium of $1,110.04 in Example 1) effectively increases the economic value of the life insurance coverage provided by the

[2] Tabular cash values are typically defined on the basis of a net premium, adjusted premium or nonforfeiture factor. Recognition of the nonforfeiture expense charge, identifiable from the fixed premium and tabular cash values (or nonforfeiture factor) that are stated on the contract specifications page, as an expense charge in the development of guideline premiums is necessary in order to establish the intended equivalence between the GLP and the gross premium.



contract to the policyholder, i.e., it is reflective of interest, mortality and expense guarantees provided by the tabular value that are more favorable in at least some durations. Defining these guarantees, as well as those relating to the accumulation account when its value is prevailing, is at the heart of the FN 53 process.

In this example, the accumulation account value prevails for the first 33 years, with the tabular cash values prevailing thereafter. Table 1 details the applicable guarantees for this contract.

Table 1: Guaranteed Assumptions under FN 53

Prevailing CV	Accumulation Account	Tabular Cash Value
Durations	1-33	34-65
Mortality	1980 CSO ALB Female	1980 CSO ALB Female
Interest	4%	6%
Expense	$60 annually	$139.69 annually

FN 53 provides the means for determining policy guarantees for a FPUL contract. Once determined, the same principles would apply to the determination of the GLP as illustrated in Example 1. Put differently, if a UL contract were designed with the guarantees outlined in Table 1, the resulting GLP would be identical to the GLP for the ISWL contract defined in this Example 2.

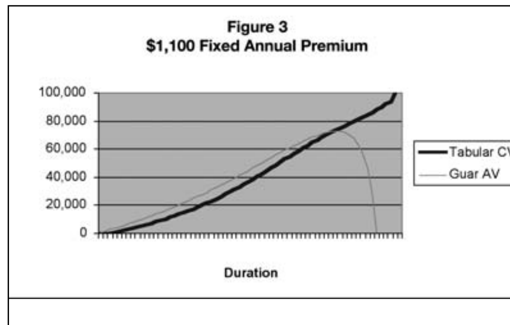
Basic actuarial principles. Not surprisingly, the determination of the GLP using basic actuarial principles and the assumptions defined in Table 1 is $1,000.00.

Projection-based methodology. In applying the projection-based approach for determining the GLP, the process involves solving for the premium that will endow the contract for the original specified amount using the assumptions set forth in Table 1. For the first 33 contract years, the projection will be based on the accumulation account guarantees. For the remaining durations, the projection will be based on the tabular value assumptions. Under this assumption set, the projected cash value will exactly mirror the set of prevailing cash values on the guarantees, and thus the GLP under the projection-based approach is also $1,000.

Example 3: FPUL Contract
(Fixed Annual Premium = $1,100)

Example 3 follows the contract design in Example 2, except the gross premium is set at $1,100. Changing the premium will result in certain changes to the contract guarantees, as both the crossover duration and the "expense charges associated with an alternate state law minimum nonforfeiture value" will be different.

Application of the FN 53 process: Figure 3 illustrates the projection of both the accumulation account value and the tabular cash values for this example. Because of the higher fixed premium in this example, the accumulation account will prevail for a longer period of time (51 years vs. 33 years). In addition, the higher fixed premium will necessarily result in higher expense charges associated with the SNFL, which effectively acts as a balancing item in the process.



As described above, applying basic actuarial principles to the determination of the GLP using the assumptions defined in Table 2 will return a GLP equal to $1,100 (the fixed premium for the contract). Similarly, under a projection-based approach, the accumulation of $1,100 annually using the Table 2 assumptions will exactly endow the contract for its original specified amount, resulting in a set of cash values equal to the prevailing cash values illustrated in Figure 3.

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Table 2: Guaranteed Assumptions under FN 53

Prevailing CV	Accumulation Account	Tabular Cash Value
Durations	1-51	52-65
Mortality	1980 CSO ALB Female	1980 CSO ALB Female
Interest	4%	6%
Expense	$60 annually	$239.69 annually

Comment on statutory requirements. As illustrated in Examples 2 and 3, the FN 53 process generally results in the equivalence between the gross premium and the GLP. This equivalence will hold true, however, only if the policy guarantees of interest, mortality and expenses, as determined by the FN 53 process, are not in conflict with the statutory requirements that restrict the allowable assumptions for computing guideline premiums. Assuming this to be the case, the upper limit on the allowable premium under the GPT for a level premium ISWL design is the GLP based on accumulation account guarantees ($1,110.04 in Example 1). With such a premium, the accumulation account would constitute the prevailing cash value for all durations in the above examples, and the tabular value thus would be irrelevant under FN 53. Any higher-level gross premium would over-endow the contract on a guaranteed basis. Any gross premium below this amount arguably results in the equivalence between the GLP and the gross premium, the intended result of FN 53.

This equivalence between the gross premium and the GLP does not necessarily guarantee compliance under the GPT, a common misconception of ISWL contracts. The process of monitoring the relationship between premiums paid and the guideline premium limitation is still necessary, particularly for those product designs that apply premiums to the accumulation account when received. The early payment of premiums, particularly those received (and applied) in one contract year, that are otherwise due in the following contract year, can result in premiums exceeding the guideline premium limitation, albeit for a short period of time. Nonetheless, these early premium payments can create contract failures under the GPT if the prevailing guideline premium limitation is based on the sum of GLPs (i.e., where the cumulative GLP exceeds the guideline single premium).

Concluding Thoughts

This article regarding FN 53 and the text of the DEFRA Bluebook associated with this footnote has largely focused on the application of these provisions to FPUL contracts, and indeed the footnote expressly speaks just to such contracts. That said, the requirement of comparing alternative prevailing cash values is much broader, and as companies consider new designs, especially some intended to protect against various types of investment risk, one needs to consider whether alternative cash values are involved with such designs that give rise to a need to perform the duration-by-duration analysis to determine prevailing cash values.

With respect to FPUL contracts, FN 53 offers the benefit of allowing a contract to be designed in a manner similar to contracts governed by the CVAT. However, given the concerns described above, considerable care needs to be taken before relying on the FN 53 approach. Arguably, companies would be better served by avoiding the common misperception that this type of contract design will result in automatic compliance under the GPT requirements.

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FASB Issues Proposed Interpretation on Accounting for Uncertain Tax Positions

by Matthew M. Haaf and Ernest C. Achtien

On July 14, 2005, the FASB issued an Exposure Draft of a proposed Interpretation, Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109. If adopted, the proposed Interpretation is the most significant tax accounting guidance the FASB has issued since FASB Statement No. 109 "Accounting for Income Taxes," (FAS 109) in 1992.

The FASB has proposed an asset recognition approach, applying a dual threshold to account for uncertain tax positions. The two thresholds are recognition and measurement, described in more detail below. Currently, uncertain tax positions are accounted for under the FASB Statement No. 5, "Accounting for Contingencies," (FAS 5) liability approach. Generally, FAS 5 provides that an estimated loss from a loss contingency should be accrued if it is probable that an asset has been impaired, or a liability was incurred and the amount of the loss can be reasonably estimated. The proposed Interpretation would apply to all open tax positions accounted for in accordance with FAS 109, including those acquired in business combinations.

The proposed Interpretation would be effective as of the end of the first fiscal year ending after Dec. 15, 2005. The proposed Interpretation was open to public comment, with comments due to the FASB by Sept. 12, 2005. Many accounting professionals familiar with the proposed Interpretation believe the FASB will delay the effective date to allow for sufficient time to address the comment letters and for companies to implement the proposed Interpretation. Changes may be made by the FASB to the pronouncement resulting from comments received.

For many companies, implementation of the proposed Interpretation will be a significant undertaking, involving a thorough analysis of all of the company's tax positions, not just the aggressive or controversial tax positions. This includes all taxing jurisdictions, i.e. federal, foreign and state.

Initial Recognition

The initial recognition of the effect of applying the proposed Interpretation would be a cumulative effect of a change in accounting principle (i.e., the amount would be shown as an item on the income statement between the captions "extraordinary items" and "net income").

Under the proposed Interpretation, the recognition of a tax benefit would occur when it is "probable" that the position would be sustained upon audit. The proposed Interpretation refers to the FAS 5 definition of probable (i.e., that which is likely to occur), which represents a level of assurance that is substantially higher than "more likely than not."

Generally, the "probable" threshold has been interpreted as a 70 percent or more likelihood of sustaining the tax position. The "more likely than not" threshold has been defined as a likelihood of sustaining the position of 50 percent or more.

The Board noted that, in determining if the "probable" threshold has been met, it should be assumed that the taxing authority will examine the tax position. Examples of specific facts and circumstances that may, in the absence of opposing evidence, demonstrate a probable level of confidence are as follows:

- Unambiguous tax law supporting the tax position.
- An unqualified "should prevail" level tax opinion from a qualified expert.
- Similar positions that have, obviously been presented in the tax return and have been either accepted or not disallowed or challenged by the taxing authority.

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If the tax benefit meets the "probable" threshold, the measurement of the tax benefit is based on the "best estimate" of the ultimate tax benefit that will be sustained upon audit by the taxing authority.

- Case law representing a favorable resolution of similar positions.

If the probable threshold is not met for a tax position, then none of the tax benefit would be recognized currently. The proposed Interpretation includes an example of a tax position that was not probable of being sustained on audit but the company's prior experience indicated the position would be settled for 10 percent of the claimed benefit. The proposed Interpretation provides that, because the probable threshold has not been met, none of the benefit should be recorded.

Recognition/Derecognition

Under the proposed Interpretation, a tax position that fails to meet the "probable of being sustained" threshold for initial recognition can be recognized in a later period in which the probable threshold is met. A tax benefit initially recognized when it meets the "probable of being sustained" threshold would be derecognized in the period in which the likelihood of the position being sustained drops below "more likely than not."

Measurement

If the tax benefit meets the "probable" threshold, the measurement of the tax benefit is based on the "best estimate" of the ultimate tax benefit that will be sustained upon audit by the taxing authority. The "best estimate" is not a probability-weighted estimate, but the single most likely outcome. A subsequent change in best estimate, with respect to a tax position taken in a prior period, should be treated as a discrete event occurring in the period when the change of judgment occurs.

Classification

The Board concluded that the liability arising from the difference between the tax position and the amount recognized and measured under the proposed Interpretation should be classified as a current liability if anticipated to be paid within one year or the operating cycle, if longer. Only a liability related to a taxable temporary difference, as defined in FAS 109, should be classified as a deferred liability.

Interest and Penalties

The proposed Interpretation notes that if the payment of interest on the underpayment of income taxes is required by the relevant tax law, the accrual of interest should be based on the difference between the tax benefit recognized in the financial statements and the tax position on the tax return. Interest shall be accrued in the period the interest is deemed to have been incurred. If a penalty applies to a tax position, the liability for the penalty should be recognized in the period the penalty is deemed to have been incurred. The board did not consider the classification of interest and penalties, and believes that topic would be more appropriately considered as part of the IASB convergence project, if at all.

Some of the public comments posted on the FASB Web site indicate a strong disagreement over a move to the "asset" recognition approach from the historical FAS 5 liability or impairment approach. The comments suggest that with additional guidance from the FASB the liability approach is the fundamentally more appropriate approach. Also, many of the comments suggest that the use of the higher probable standard and not the more likely than not standard will result in increased tax expense that will only need be reversed in subsequent periods as the statute of limitations expires. The companies that submitted comments were strongly opposed to an effective date that would require companies to adopt the proposed Interpretation for years ending Dec. 31, 2005.

While the final form of the proposed Interpretation is uncertain and it is not known when it will become effective, it is certain that companies will have new rules for accounting for income taxes, and will have to devote increased resources to determining the proper accounting for uncertain tax positions.

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Experience Rating, *Helvering vs. Le Gierse*, and COLI/BOLI Arrangements

by Kirk Van Brunt

Almost 65 years ago, the Supreme Court issued its opinion in *Helvering v. Le Gierse*,[1] addressing when an arrangement should be recognized as involving "insurance" for federal income tax purposes. According to the Court, an "insurance risk" must be present, and for an insurance risk to exist, there must be "risk-shifting and risk distribution."[2] In reading the opinion, one senses that the court thought that it was merely stating the obvious. If the court had been able to peer into the future, it probably would have been surprised to see the critical significance that those two terms—"risk-shifting" and "risk distribution"—would take on under the tax laws, and how much time and effort taxpayers, the IRS and courts would spend down through the years parsing out the meaning of those two terms. Yet, those two terms continue to dominate the tax analysis of whether an arrangement is insurance or not.[3]

Historically, most of the litigation over risk shifting and distribution has been in the property-casualty arena. It is less commonly raised as an issue with individual life insurance, particularly since the enactment of section 7702, except in situations where the facts are similar to those of *Le Gierse*.[4] In recent years, however, the IRS has been raising the issue of risk-shifting and risk distribution in its litigation over leveraged corporate-owned life insurance (COLI), where the policies in question provided for experience rating. The IRS has advanced the argument, with some success, that by virtue of the experience rating mechanism in a group of policies, the corporate policyholder is essentially paying its own death claims.[5] Although risk-shifting and risk distribution exists at the level of each individual policy considered in isolation, this is not the case in the aggregate with respect to the entire COLI arrangement, the IRS has argued.[6] The net effect of the total COLI arrangement is that there is no risk transfer; according to the IRS, the arrangement is "mortality neutral." The concept of mortality neutrality is a great deal reminiscent of *Le Gierse*: the annuity contract and life policy in *Le*

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[1] 312 U.S. 531 (1941).

[2] 312 U.S. at 539-40. In *Le Gierse*, an insurance company simultaneously issued a single premium, immediate life annuity contract and single premium life insurance policy to an individual. The one instrument would not have been issued without the other, and collectively the two operated to cancel out any mortality risk being shifted to the insurance company. Stated differently, the risk of loss from premature death shifted to the insurance company under the life insurance policy was exactly offset by the risk of loss from premature death shifted back to the policyholder under the annuity contract.

[3] Most recently, see, e.g., Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (addressing the risk-distribution prong of the test where an insurer insures only one or a small number of independent risks).

[4] This is not to say that there are never any *Le Gierse* issues after the enactment of section 7702. There are, e.g., the issue can arise when an insured attains age 100 and the section 7702 "corridor" drops to zero. However, we leave for another day the question of how *Le Gierse* interacts with section 7702.

[5] See *American Elec. Power, Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003), aff'g 136 F. Supp. 2d 762 (S.D. Ohio 2000), cert. denied 540 U.S. 1140 (2004); *IRS v. C.M. Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), aff'g 254 B.R. 748 (D. Del. 2000); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999), cert. denied, 535 U.S. 986 (2002). Cf. *Dow Chemical Company and Subsidiaries v. United States*, 250 F. Supp. 2d 748 (E.D. Mich.), modified in part upon reconsideration, 278 F. Supp. 2d 844 (2003) [Currently on appeal to the Sixth Circuit].

[6] See, e.g., American Elec. Power, supra note 5, at 326 F.3d at 742-43.

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Gierse each involved risk shifting and risk distribution when considered separately, but collectively the two contracts offset one another and there was no net transfer of risk—i.e., the annuity-life policy arrangement, considered in its entirety, was "mortality neutral."

While leveraged COLI lived a short life and died an inglorious death, the IRS's attack on mortality neutrality continues to be a source of concern for other COLI arrangements. There is an active and vigorous market for nonleveraged COLI and bank-owned life insurance (BOLI). COLI/BOLI remains an attractive investment vehicle for funding certain liabilities, such as employee benefit obligations. Often, however, these COLI/BOLI arrangements possess experience-rating mechanisms that, to varying degrees, aspire to achieve a measure of mortality neutrality. In the aftermath of the leveraged COLI litigation, concerns have deepened as to whether these traditional COLI/BOLI arrangements could be within reach of the long arm of *Le Gierse*. To be sure, in the leveraged COLI litigation, the IRS argued that the existence of mortality neutrality demonstrates that the arrangements are sham transactions, lacking in economic substance; the IRS did not specifically argue that the arrangements were not insurance under *Le Gierse*. Moreover, as a general matter, probably most practitioners in the area would not consider the typical traditional COLI/BOLI to be substantially susceptible to a sham transaction analysis. However, there is no indication that the IRS views its mortality neutrality argument as limited just to cases involving shams.

How should COLI/BOLI arrangements be structured in order to avoid the argument that they are not insurance under *Le Gierse* because of mortality neutrality? There are several points to consider in this regard (in no particular order):

- *Avoid experience rating altogether*. This would solve the problem, but unfortunately competitive and financial pressures within the COLI/BOLI marketplace may make this solution impractical.

- *Avoid formulaic experience rating*. The more experience credits or refunds are discretionary with the insurer, and the less they are contractually guaranteed or fixed by formula (either in the policies or via a side letter), the better. Unfortunately, this often means opposing the policyholder, whose natural inclination is to have everything contractually spelled out in as much detail as possible. This should be avoided. The insurer should retain some meaningful element of discretion regarding the payment of experience credits or refunds.

- *Steer clear of perfect mortality neutrality*. The *Le Gierse* case involved perfect mortality neutrality, but it probably should not be read as limited to only such situations. Accordingly, there should always be some meaningful, non-trivial mortality risk being shifted to the insurer. How much is enough? Opinions vary. This is the fundamental flaw with the *Le Gierse* risk-shifting/risk distribution analysis: it does not address the quantum of risk that must be shifted and distributed. For example, is it enough that the insurer is potentially at risk only in the event that mortality experience is worse than a stated maximum, such as 1980 CSO? Is it enough that the insurer is potentially at risk only in the event of a major catastrophe? Maybe, or maybe not. The only clear answer is the more risk, the better. Ideally, there should be a meaningful probability that the insurer will bear the loss from premature death.

- *Prospective vs. retrospective*. To date, the government's only loss in its leveraged COLI litigation was the *Dow Chemical* case.[7] One key fact cited by the Court in distinguishing Dow Chemical from the other leveraged COLI cases was that the experience rating mechanism operated on a prospective basis. The arrangement did not provide for a retrospective true-up mechanism.[8] Adhering to this distinction would be a good idea. Thus, as part of avoiding perfect mortality neutrality, retrospective true-up devices should be avoided if at all possible. Instead, past mortality experience should only be taken into account by adjusting prospective future charges or interest credits.

In summary, it is common for traditional, nonleveraged COLI/BOLI arrangements to provide for some form of experience rating. However, in the wake of the IRS's mortality neutrality argument in the leveraged COLI litigation, concerns exist as to whether this argument could be turned against traditional COLI/BOLI arrangements to assert that they do not constitute insurance under the risk-shifting/risk distribution standard of *Le Gierse*. For this reason, insurers may want to take affirmative steps to structure experience rating mechanisms so as to reduce the risk of a mortality neutrality argument. ◂

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[7] See Dow Chemical, supra note 5. It should be noted, however, that the case is on appeal to the Sixth Circuit, which has not yet rendered a decision as of the date this article went to press.

[8] See Dow Chemical, supra note 5, at 779-80, 782.

The Impact of IRS Schedule M-3 on Insurance Companies

by Amy C. Lewis and Ernest C. Achtien

Year 2004 marked the first tax-filing year that certain corporate taxpayers were required to file the newly created IRS Schedule M-3–designed as a replacement for the Schedule M-1, which is used to reconcile a corporation's financial accounting income or loss with its taxable income or loss. The purpose of Schedule M-3 is to provide more transparency and consistency among taxpayers than Schedule M-1 in reporting differences in between financial accounting net income and taxable income. The IRS believes that Schedule M-3 will enable its agents to more effectively and efficiently identify returns and issues warranting examination.

Schedule M-3 is currently required for corporate taxpayers with assets of $10 million or more that file Form 1120, U.S. Corporation Income Tax Return, for tax years ending on or after Dec. 31, 2004. Taxpayers who are required to file Schedule M-3 do so in lieu of Schedule M-1. In addition, the IRS plans to expand Schedule M-3 filing requirements to other taxpayers, including partnerships that file Form 1065, foreign corporations that file Form 1120-F, S corporations that file Form 1120-S, and insurance companies that file Form 1120-L and Form 1120-PC. Schedule M-3 and instructions are available on the IRS Web site at *www.irs.gov*.

As provided by the 2004 Schedule M-3 instructions, insurance companies are not required to file Schedule M-3 unless an insurance company is a member of a consolidated group whose parent corporation files a Form 1120 and is required to file Schedule M-3. Insurance companies who file as part of a consolidated return have the option of fully completing Schedule M-3 as if the insurance company filed an 1120, or by including the sum of all the differences between the insurance company's financial accounting net income and taxable income on a single line of the M-3, and adequately disclosing each difference in a supporting schedule. Due to the unique nature of some insurance company financial income to taxable income differences, such as differences in reserves, insurance companies may have difficulty correctly classifying certain differences on the current M-3 line items.

In June 2005, the Treasury Department and the IRS issued a draft version of the 2005 Schedule M-3 and related instructions for use by certain corporate taxpayers filing Form 1120. The 2005 Schedule M-3 instructions were not changed with regard to the requirements for insurance companies filing in a consolidated return with a parent company that files a Form 1120. When the Service finalizes and issues a Schedule M-3 for use with Forms 1120-PC and 1120-L, it is reasonable to assume that the instructions for the Form 1120 Schedule M-3 regarding this issue will also be changed.

The IRS announced in June that the planned effective date for Schedule M-3 for Forms 1065 and 1120-S was Dec. 31, 2006. However, at that time the Service planned to release Schedule M-3 for Forms 1120-PC and 1120-L in 2005, effective for tax years ending on or after Dec. 31, 2005. On Sept. 16, 2005, the Service announced that it was deferring the planned effective date for the Schedule M-3 for Forms 1120-PC and 1120-L to tax years ending on or after Dec. 31, 2006. As the purpose of Schedule M-3 is to increase transparency, insurance companies should be prepared to provide more detailed information related to the 2006 tax year on differences between financial statement income and taxable income than previously required by Schedule M-1.

To date, the IRS has not released a draft Schedule M-3 and instructions for Forms 1120-PC and 1120-L; however, the Service stated that the drafts would be released soon in the Sept. 16, 2005 press release. After the release of a draft form and instructions, the Service usually grants a 60-day comment period for public responses and questions on the drafts and then issues a revised form and instructions based on the comments. The release of the draft Schedule M-3 and related instructions will allow insurance companies to gain an understanding of the additional information that will be needed to complete the schedule for the 2006 tax year. ◂

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Profile of the Taxation Section

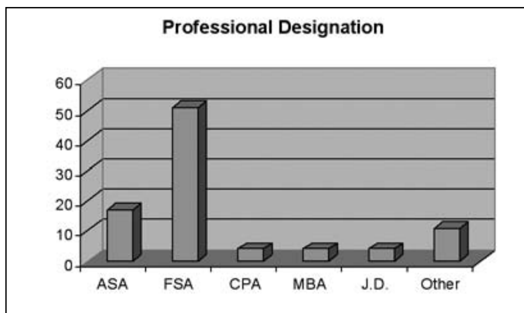
by Brian G. King

Who are the members of the Taxation Section? Where do they work? What designations do they have? What is the profile of our membership? Last spring, the Taxation Section, with the help of the SOA staff, conducted a survey of its membership. The intent of this survey was to understand the demographics of our membership and to determine areas of interest and focus within our membership.

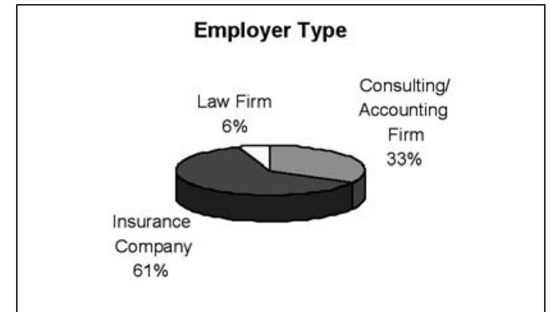
The survey was conducted via a link e-mailed to our 400-plus members. Although 159 members accessed and opened the survey link, only 104 members actually started responding to the survey questions. Of these members, 69 completed the survey. The survey results reflect all responses including partially filled out responses.

Professional Affiliation, Designation and Employer Type

It should come as no surprise that the majority of the respondents are actuaries with an FSA designation. However, we also have representatives from the accounting and legal fields with professional designations including CPA, MBA and J.D.

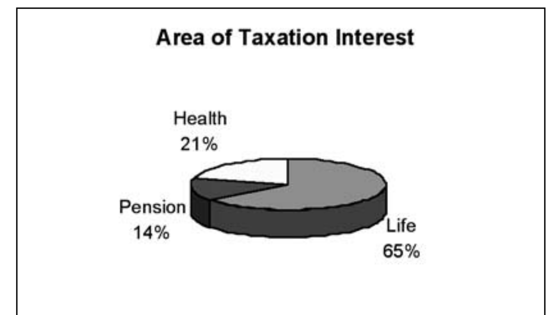


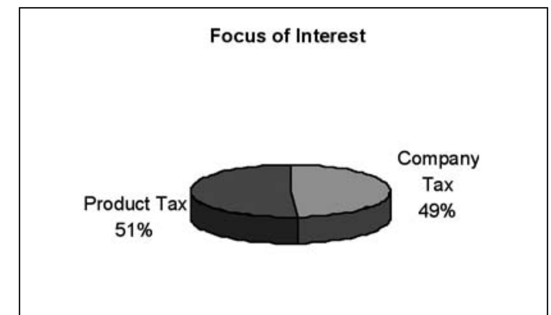
While over half of the respondents work for insurance companies, one-third work for consulting or accounting firms and 6 percent work for law firms.



Focus of Interest

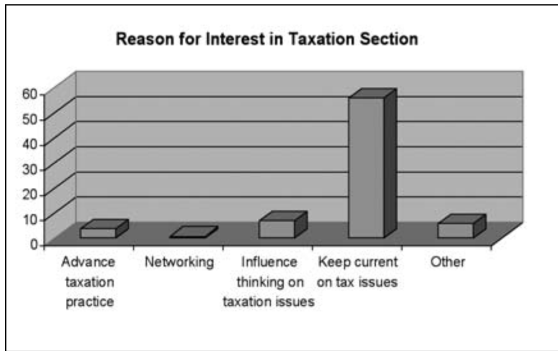
The majority of respondents listed their area of taxation interest as life insurance. There was, however, interest in taxation issues for health and pension insurance as well.





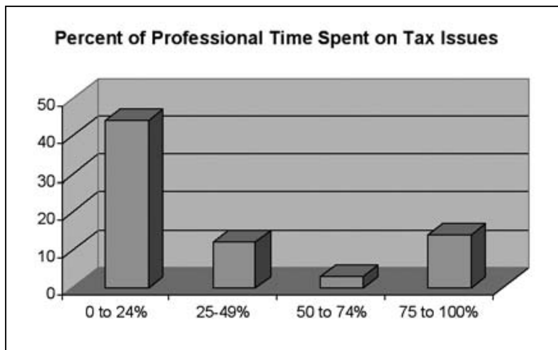
Respondents were pretty evenly split on focus of interest between product and company tax topics.

According to respondents, the primary reason for interest in the Taxation Section was to keep current on tax issues. This is consistent with the Taxation Section goal of promoting the exchange of knowledge on tax issues. Members are also interested in advancing their taxation practice, networking and influencing tax issues.

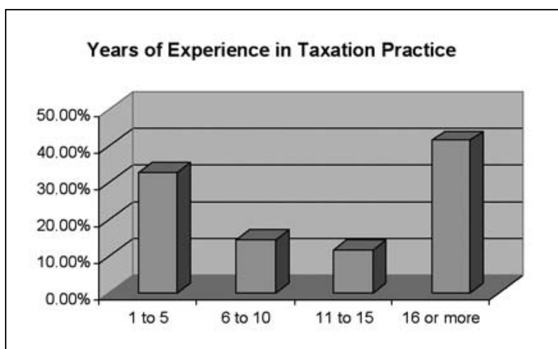


Experience With and Time Spent on Tax Practice

The majority of respondents (60 percent) spent less than a quarter of their professional time on tax issues, however almost 20 percent of respondents spent 75 percent to 100 percent of their time with taxation issues.



For years of experience in the taxation practice, the highest concentration of responses fell in the one to five years or 16 or more years brackets.



Conclusions

Although there were no real surprises with the survey results, it is good to look at a snapshot of our membership to get a sense of their interests and concerns. At future times we will conduct additional surveys through our section Web page at the SOA Web site. We encourage all our members to participate in future surveys. ◄

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