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How to Value an "Additional" Annuity Benefit (Whatever That Is)

by Joseph F. McKeever, III and Mark E. Griffin

The income tax regulations under section 401(a)(9)[1] require that required minimum distributions (RMDs) from a deferred annuity contract for calendar years beginning after 2005 must be increased for the "actuarial present value" (APV) of "any additional benefits" that will be provided under the contract. As a practical matter, the responsibility for calculating these values required under the regulations will fall on annuity issuers. In the case of an IRA annuity contract, the issuer of the contract must either inform the owner of the amount of any RMD required for the year or offer to calculate the amount of the RMD.[2] With respect to other types of annuity contracts that are subject to the section 401(a)(9) minimum distribution requirements, the individuals for whose benefit the arrangements are maintained realistically cannot be expected to apply the APV requirement to their arrangement and, likely, will look to the issuers to apply the requirement in any event.

Questions about how to apply the APV requirement have resulted in a significant amount of uncertainty on the part of tax practitioners, actuaries, and insurance company personnel responsible for modifying administrative procedures and systems to implement the requirement by the end of 2005. It appears that neither the Internal Revenue Service (IRS) nor the Treasury Department are currently contemplating issuing any guidance on the subject.[3] Nevertheless, the regulations provide a fair amount of flexibility in applying the APV requirement, and thus permit a range of acceptable actuarial present values with respect to a benefit under a deferred annuity contract.

This article considers the types of "additional" benefits that might be covered by the APV requirement, certain assumptions that might be used in computing the actuarial present value of these benefits, and certain methods of performing the computation. As discussed below, there might be a number of different assumptions and methods for computing the actuarial present value of a benefit that are reasonable.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[2] *See* I.R.S. Notice 2002-27, 2002-1 C.B. 814.

[3] As of the date this article was written, a working group created by the Taxation Section of the Society of Actuaries was preparing a discussion paper on the APV requirement in an effort to provide annuity issuers with some helpful guidance on the requirement.

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SOCIETY OF ACTUARIES

FROM THE EDITOR

BRIAN G. KING

Hello readers. I hope you all enjoyed the premiere issue of *Taxing Times* and have been looking forward to reading this subsequent issue. The premiere issue, along with future issues, can be accessed directly from our section Web page on the SOA Web site. For those of you that have visited the SOA Web site recently, you may have already noticed its new look. These changes are giving sections a more prominent place on the Web site, and giving section members greater control over the content on their Web pages. This will be a positive for all sections including our Taxation Section.

The short-term goals of these SOA initiatives are to give section leaders and members easier access to their section Web pages, the ability to post timely announcements and increased flexibility in its organization and content. The short-term changes will also provide sections with the capability to hold surveys. The SOA began a pilot program for implementing these short-term changes this summer with four sections participating. For the Taxation Section, the short-term changes should be implemented by early fall.

Longer-term, the SOA goals for section Web pages include continuing with even greater flexibility in structure and appearance and the implementation of discussion forums. These discussion forums along with the other changes to the Web pages will provide a tremendous tool for furthering the Taxation Section goal of facilitating our knowledge exchange.

Over the summer, the Taxation Section Web page provided members with a variety of information and issues concerning our section, including:

- Access to the first edition of *Taxing Times*.
- Candidate information for those running for a position on the Taxation Section Council.
- Links to access information including the Proposed Regulation dealing with "Attained Age" under IRC Sections 7702 and 7702A.
- Posting of a research report on "Required Minimum Distributions."

As we continue to add content to our Web page, we will e-mail update notifications to our members. Our goal is to provide our members with information in a timely fashion. Remember, the exchange of tax knowledge is the mission of our section. Through the modifications made to the section Web pages, the SOA has given us a powerful tool in furthering our mission. I encourage all of you to visit the Web page as updates are made and contact me if there are topics, current announcements or issues that you feel should be added to the site.

Enjoy this issue of *Taxing Times*, and remember to visit us on the Web!

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.

TAX RESERVE PLANNING MATHEMATICS

EDWARD L. ROBBINS

The purpose of this article is to suggest some quantitative approaches for evaluating tax reserve planning strategies. Although there is not a great deal of literature about the application of these approaches to tax planning, the approaches themselves should be familiar to many actuaries. Certain options, explicit and implicit, exist in the calculation of tax reserves, and it is useful to have quantitative tools for evaluation of the alternative options.

Background

In the business world, every material expenditure should be weighed against the subsequent resulting marginal returns to the investors or owners as a result of that expenditure. Similarly, in our life insurance company environment, a currently contemplated use of free surplus should be weighed against the subsequent resulting marginal returns to free surplus via some reasonable metric.

The concept of embedded value (EV) has been used by multinational companies for many years as a metric to gauge the attractiveness of a given investment or strategy. This concept can also be applied to gauge the attractiveness of a tax planning strategy.

Embedded value, as the term has come to be used, is the sum of two values:

1) The present value of future distributable earnings, at a selected cost-of-capital rate, given that statutory reserves plus required surplus will eventually be released.

2) Given the assets required for 1), above, the balance of the company's cash and invested assets are adjusted to market value, assumed to be sold and thus valued at their post-sale value after taxes on disposition.

Tax reserves and related items are functions of product design but also subject to the manner in which statutory reserves are calculated. Thus, one can look at tax and statutory reserve alternatives in combination with required surplus in concluding on optimal reserving structures. Essentially, on comparing Alternative A versus Alternative B by use of a concept which we will call marginal embedded value (MEV), we can see whether Alternative B is "incremental or erosive" to EV relative to Alternative A. Put differently, the question becomes, "Is the MEV generated from moving from Alternative A to Alternative B positive or negative?"

The three key ingredients of this analysis are total assets required (TAR), statutory reserves (SR), and tax reserves (TR), where TAR minus SR equals required capital. TAR is thus the determinant of free surplus, while statutory reserve structure has a large influence on tax reserve structure. For purposes of formula simplification, in this document SR is used as a proxy for TAR and assumed to be equal to TAR. In reality, in most cases the TAR is greater than the SR, thus generating positive required capital. Thus any conclusion that suggests that a lower SR may be attractive will need further analysis, recognizing that the TAR might require commensurately more capital. From a tax perspective, the statutory reserve structure, or a portion thereof, must meet certain tax criteria specified in the Internal Revenue Code and related guidance, and any remaining reserve will not be deductible (thus the components are important).

Quantifying MEV

Assume that Alternative B generates a higher initial total (supporting) asset requirement (TAR) than Alternative A. (Call that difference in total asset requirement "ΔTAR".) When a higher tax reserve also generates a higher TAR, the advisability of Alternative B relative to Alternative A can be approximately expressed mathematically as the rate of return on the initial use of free surplus, as follows:

Definitions:

K = Ratio of tax reserve increment to "ΔTAR."
R = Marginal income tax rate.
I = Investment income rate after Federal Income Tax.
IRR = Internal Rate of Return generated in going from Alternative A to Alternative B. Assume the Alternative B reserve requirement is greater than the Alternative A requirement.

The general formula for generating the IRR from such an increase in reserves is given by:

IRR = I/(1-R*K)

The derivation of the formula is in the appendix to this memorandum.

That IRR can then be compared with the entity's cost of capital rate, or the return the entity can achieve by otherwise deploying free surplus. An IRR greater than the cost of capital rate will develop a positive MEV.

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Section 401(a)(9) and the Actuarial Present Value Requirement

Section 401(a)(9) sets forth certain minimum distribution requirements that apply to qualified plans under section 401(a), tax-sheltered annuity contracts and custodial accounts under sections 403(b)(1) and 403(b)(7), individual retirement accounts and annuity contracts under sections 408(a) and 408(b), Roth IRAs under section 408A and eligible deferred compensation plans under section 457(b). The regulations under section 401(a)(9) provide one set of rules for applying the minimum distribution requirements to arrangements that are in the form of individual accounts and another set of rules for defined benefit plans and annuity contracts that have annuitized. With respect to an individual account, the regulations provide that if a minimum distribution is required for a calendar year, the amount of the required distribution for the year is equal to the quotient obtained by dividing the account balance, as of the last valuation date in the immediately preceding calendar year, by the applicable distribution period determined under the regulations.[4]

In the case of a deferred annuity contract, Treas. Reg. section 1.401(a)(9)-6, Q&A-12, states that prior to the date that an annuity contract under an individual account plan is "annuitized," the interest of an employee or beneficiary under the contract is treated as an individual account for purposes of section 401(a)(9). In applying the individual account rules to a deferred annuity contract, the "entire interest" under the contract as of Dec. 31 of the relevant valuation calendar year is treated as the account balance for the valuation calendar year. The "entire interest" under a deferred annuity contract is equal to the sum of (1) the "dollar amount credited" to the employee or beneficiary under the contract, also referred to in the regulations as the contract's "notional account value," plus (2) the "actuarial present value" of "any additional benefits (such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary) that will be provided under the contract."[5]

The preamble to the regulations states that the IRS and the Treasury Department believe it is generally appropriate to reflect the value of additional benefits under an annuity contract, "just as the fair market value of all assets generally must be reflected in valuing an account balance under a defined contribution plan."[6]

Benefits Expressly Excluded from the APV Requirement

Q&A-12 sets forth three special rules providing that additional benefits under a deferred annuity contract may be disregarded, and thus not subject to the APV requirement, if they fall within what is referred to herein as (1) the "120 percent exclusion," (2) the "ROP benefit exclusion" or (3) the "IRS guidance exclusion," discussed next:

1. The 120 percent exclusion

The APV of any additional benefits provided under an annuity contract may be disregarded if "the sum of the dollar amount credited to the employee or beneficiary under the contract and the actuarial present value of the additional benefits" (i.e., the "entire interest" under the contract) is no more than 120 percent of the dollar amount credited to the employee or beneficiary under the contract and "the contract provides only for the following additional benefits:"

a. Additional benefits that, in the case of a distribution, are reduced by an amount sufficient to ensure that the ratio of such sum (i.e., the entire interest) to the dollar amount credited does not increase as a result of the distribution ("Pro-Rata Reduction" benefits),[8] or

[4] Treas. Reg. § 1.401(a)(9)-5, Q&A-1.

[5] The APV requirement does not apply for periods after annuity payments have commenced under the contract. Instead, the rules applicable to defined benefit plans and annuitized contracts apply. *See* Treas. Reg. § 1.401(a)(9)-6.

[6] 69 Fed. Reg. 33292 (June 15, 2004).

[7] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1).

[8] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1)(i). The preamble to the regulations describes the 120 percent exclusion generally as applying when there is a pro-rata reduction "in the additional benefits for any withdrawal." 69 Fed. Reg. 33292 (June 15, 2004).

b. An additional benefit that is the right to receive a final payment upon death that does not exceed the excess of the premiums paid less the amount of prior distributions (an "ROP" benefit).[9]

It is unclear whether a Pro-Rata Reduction benefit under the 120 percent exclusion can include a benefit that, in the case of a distribution, is reduced by an amount equal to the dollar amount of the distribution (a so-called "dollar-for-dollar" benefit). Depending on the facts and circumstances at any time, a distribution from an annuity contract with a dollar-for-dollar benefit could reduce the benefit at that time by a percentage that is less than, equal to, or greater than the percentage reduction in the entire interest under the contract as a result of the distribution. Under one interpretation of the 120 percent exclusion, a dollar-for-dollar benefit could never qualify as a Pro-Rata Reduction benefit merely because it is *possible* for a distribution to reduce a dollar-for-dollar benefit by a percentage that is less than the resulting percentage reduction in the entire interest under the contract. Under an alternative interpretation, a dollar-for-dollar benefit (1) would constitute a Pro-Rata Reduction benefit for a year if, at the time the RMD for the year is to be calculated, a distribution would reduce the benefit by a percentage that is equal to or greater than the resulting percentage reduction in the entire interest under the contract, and (2) would not constitute a Pro-Rata Reduction benefit for a year if, at the time the RMD for the year is to be calculated, a distribution would reduce the benefit by a percentage that is less than the resulting percentage reduction in the entire interest under the contract. It is unclear which interpretation is correct. The authors believe that the second interpretation is consistent with the regulations and hope that the IRS will eventually clarify that it is the proper interpretation of the exclusion.

2. The ROP Benefit Exclusion

If the only additional benefit provided under a deferred annuity contract is an ROP benefit, its value need not be taken into account in computing RMDs, regardless of its value in relation to the dollar amount credited to the employee or beneficiary under the contract.[10]

The APV requirement applies by its term to "any" additional benefits under a deferred annuity contract … however, neither the regulations nor the preamble thereto provide any indication as to the types of other benefits that should be covered by this requirement.

3. The IRS Guidance Exclusion

The IRS may issue revenue rulings, notices or other guidance published in the Internal Revenue Bulletin that identify additional benefits that may be disregarded for purposes of applying the APV requirement.[11] As of the date this article was written, no such guidance has been issued.

Types of Benefits Covered by the APV Requirement

The APV requirement applies by its terms to "any" additional benefits under a deferred annuity contract. Q&A-12 states that the requirement applies to benefits "such as survivor benefits in excess of the dollar amount credited to the employee or beneficiary" that will be provided under the contract. Beyond this statement, however, neither the regulations nor the preamble thereto provides any indication as to the types of other benefits that should be covered by this requirement.

The two examples set forth in Q&A-12(d) treat as an additional benefit a death benefit that is provided until the end of the calendar year in which the owner attains age 84 equal to the greater of the current "notional account value" and the largest notional account value at any previous policy anniversary reduced proportionally for subsequent partial distributions (a "high water mark" benefit). Presumably, the APV requirement also

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[9] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(1)(ii).

[10] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(2).

[11] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(c)(3).

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applies to other types of death benefits that are payable upon the employee's death and are in excess of the amount credited to the employee or beneficiary under the contract, such as: (1) a death benefit that generally pays the greater of the contract's cash value on the date of death and the net premiums paid for the contract plus interest at a stated rate (often called a "rollup" benefit), and (2) a death benefit that generally pays a stated percentage of the excess of the cash value over the unrecovered premiums paid under the contract (often called an "earnings enhancement" benefit).

Notwithstanding requests by commentators on the APV requirement set forth in proposed regulations issued in 2002[12] that the requirement should not apply to lifetime benefits, Q&A-12 is not limited to death benefits. The language in Q&A-12 indicates that "any" benefit that can provide amounts payable in excess of the amounts credited under the contract might be treated as an additional benefit subject to the APV requirement. Hence, the APV requirement almost certainly applies to certain lifetime benefits, such as: (1) guaranteed minimum income benefits providing a stream of annuity payments guaranteed to be at least some minimum amount regardless of the contract's actual cash value, (2) guaranteed minimum withdrawal benefits providing the right to withdraw a certain stated percentage of contributions each year for a specified duration regardless of the contract's actual cash value, and (3) guaranteed minimum accumulation benefits providing a guaranteed minimum cash value at certain specified times.

There is some uncertainty about whether and how Q&A-12 applies to various provisions under a deferred annuity contract. Although it is unclear, presumably the IRS and Treasury Department did not intend for the benefits associated with certain contract provisions that historically have been integral features of annuity contracts, such as annuity purchase rate guarantees and minimum interest rate guarantees, to be treated as "additional benefits" in excess of the amount credited under the contract for this purpose. After all, these benefits are not "additional" to the annuity contract in that they comprise basic elements of the contract. However, there is more uncertainty regarding the treatment of some other features of deferred annuities, such as equity-indexed adjustment (EIA) provisions, market value adjustment (MVA) guarantees under a contract, waiver of premium provisions, and waiver of surrender charge provisions.

It is unclear whether such features should be: (1) taken into account under Q&A-12 as part of the "dollar amount credited" under the contract, (2) treated as additional benefits subject to the APV requirement, or (3) viewed as neither part of the dollar amount credited nor additional benefits, and thus ignored for purposes of Q&A-12. In addition, if such a feature is subject to the APV requirement, questions exist regarding the treatment of negative values (such as a negative MVA) that might arise in certain cases.

Methods of Computing the Actuarial Present Value of Additional Benefits

The preamble to the regulations states that the examples set forth in Q&A-12(d) illustrate "an acceptable method" of determining the value of an additional benefit that is a guaranteed death benefit.[13] In general, the examples apply certain assumptions, discussed below, to arrive at the actuarial present value of the additional benefit by: (1) determining the value of the benefit for each year the benefit might be payable under the contract, (2) arriving at the actuarial present value with respect to each year's benefit, and (3) summing the actuarial present values for all the years the benefit might be payable. The value of an additional benefit for a year is determined generally in the examples as the product of: (1) the amount of the benefit payable during the year, (2) the probability that the employee or beneficiary, whichever is applicable, will survive to the year, and (3) the probability that the benefit will be paid in the year.

Accounting for Charges

For purposes of determining the APV with respect to an additional benefit for a year, the examples apply a discount rate to the value of the benefit for the year. Although it is not addressed in Q&A-12 or the examples thereunder, and the answer is unclear, it seems appropriate to reduce the present value of the additional benefit by the present value of the charges for

[12] *See* Prop. Treas. Reg. § 1.401(a)(9)-6, Q&A-12.

[13] 69 Fed. Reg. at 33292.

purposes of determining RMDs. If the present value of future charges is ignored, the RMD that is calculated for a year could be overstated.

For instance, assume that a deferred annuity contract provides an additional benefit equal to a constant amount that does not change from year to year. Assume further that the additional benefit can be purchased with a single premium at issuance of $2,000 or can be funded through periodic charges imposed against the cash value under the contract. Presumably, the actuarial present value of the benefit at issuance should be equal to the $2,000 that it would cost to purchase the benefit with a single premium at that time.

Consider an individual who uses $100,000 to purchase a contract with this benefit on Dec. 31 of year 1. In accordance with Q&A-12, the amount of the RMD for year 2 should be determined under the individual account rules as an amount equal to the quotient obtained by dividing (1) the account balance as of Dec. 31 of year 1, i.e., the "entire interest" in the contract as of that date, by (2) the applicable distribution period determined under the regulations.

If the individual applies $2,000 of the $100,000 to pay the single premium for the benefit, there will be no future charges under the contract for the benefit. At the time the contract is issued, the amount credited under the contract of $98,000 ($100,000 - $2,000), plus the actuarial present value of the additional benefit ($2,000), less the present value of the future charges for the benefit ($0), equals the $100,000 consideration paid for the contract. This total amount arguably is appropriately viewed as the fair market value of the contract on Dec. 31 of year 1 and the amount on which the RMD for year 2 should be determined.

Alternatively, the individual could choose to pay for the benefit through periodic charges imposed against the contract's cash value. At the time the contract is issued, the amount credited under the contract ($100,000), plus the actuarial present value of the additional benefit ($2,000), less the present value of the future charges for the benefit ($2,000), equals the $100,000 consideration paid for the contract. Again, this total amount arguably is appropriately viewed as the fair market value of the contract on Dec. 31 of year 1, and the amount on which the RMD for year 2 should be determined. If the present value of the future charges is not accounted for, the RMD for year 2 would be determined based on the sum of the amount credited under the contract and the present value of the benefit (i.e., $102,000), even though that would exceed the fair market value of the contract at that time.

Under the factor approach, certain characteristics of a pool of contracts could be assigned an actuarially determined numerical factor that could be applied to the contract ... to produce a number representing the actuarial present value of additional benefit(s) provided under a contract.

The "Factor" Approach

The examples under Q&A-12 compute the actuarial present value of the additional benefit under a contract based on the characteristics specific to that contract (i.e., under a "contract-by-contract" approach). Alternatively, it might be appropriate to compute the actuarial present value of additional benefits under a contract using factors based on the characteristics of a group of contracts with similar benefits, provisions, features and guarantees (i.e., under a "factor" approach).

Under the factor approach, certain characteristics of a pool of contracts could be assigned an actuarially determined numerical factor that could be applied to the contract (e.g., to the cash value or the amount of the benefit) to produce a number representing the actuarial present value of additional benefit(s) provided under a contract. Relevant characteristics might include the type of benefit(s) provided under the contract, the issue date of the contract, the owner's age at issue, and the amount of any benefit in excess of the amount credited under the contract, to name a few. Each characteristic might be divided into ranges, each assigned its own factor. For example, separate factors might be provided for the owner's issue age depending on whether owner's age at issue is 35-40, 40-45, 45-50 and so on.

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Obviously, the success of this approach turns on making sure that the relevant characteristics and subcategories are identified and the appropriate factors are assigned to each characteristic and subcategory.

Ultimately, whether the factor approach is appropriate may depend on how close the values produced under this approach are to the values properly computed under a contract-by-contract approach like that used in the examples in Q&A-12.

Reasonable Actuarial Assumptions

The regulations state that the actuarial present value of any additional benefits described in Q&A-12 are to be determined using "reasonable actuarial assumptions, including reasonable assumptions as to future distributions, and without regard to an individual's health."[14] Issuers might need to defend their assumptions as reasonable in the event they are questioned by the IRS, a court or even a contract owner. Accordingly, issuers will want to document the basis for using whatever assumptions they utilize. It is possible that certain assumptions could be viewed as reasonable for purposes of determining the actuarial present value of certain additional benefits under particular annuity contracts issued by an insurance company and, at the same time, not viewed as reasonable when applied to different benefits or contracts offered by the company.

In this regard, the examples set forth in Q&A-12(d) involve a deferred variable annuity contract that permits the assets thereunder to be invested in a fixed account at a guaranteed rate of 2 percent. The following assumptions are used in the examples for purposes of determining the actuarial present value of the death benefit provided under the contract:

- The investment return on the "notional account value," *i.e.*, the amount credited to the employee or beneficiary under the contract, is 2 percent per annum.
- The amount of the death benefit for a year is the amount that would be payable if the owner died mid-year.
- The mortality rate is determined using the mortality table provided in Rev. Rul. 2001-62.[15]
- The mortality rate during the year is equal to a blended rate taking into account one mortality rate for the number of months in the year prior to the owner's birthday and a separate mortality rate for the number of months in the year after the owner's birthday.
- RMDs are made at the end of each year.
- Values are discounted at a rate of 5 percent.

Given that the IRS and Treasury Department view the examples as providing an acceptable method of calculating the actuarial present values of the death benefits involved, annuity issuers should take comfort that if they use these same actuarial assumptions in determining the APVs for such death benefits, the assumptions would be viewed as reasonable for purposes of Q&A-12. However, issuers are free to use different assumptions with respect to these items so long as they are reasonable. In addition, issuers should be sensitive to the possibility that due to changing facts and circumstances (e.g., a change in the interest rate environment or the issuance of guidance), assumptions that are reasonable at the time the actuarial present value of an additional benefit is computed in one year might not be viewed as reasonable when the computation is performed in a subsequent year.

Also, depending on the terms of a contract, it might be reasonable to make additional assumptions regarding such things as future distributions under the contract and the probability that any additional benefits will be paid under the contract. For instance, it might be appropriate to make certain assumptions regarding the following:

- ***Withdrawals and surrenders.*** The examples in Q&A-12(d) assume that RMDs are taken at the end of each year. Depending on the facts and circumstances, including such things as the terms of the contracts involved and the issuer's experience, it may be appropriate for the issuer to make a

[14] Treas. Reg. § 1.401(a)(9)-6, Q&A-12(b).

[15] 2001-2 C.B. 632.

different assumption about when RMDs are taken each year and to make certain assumptions regarding the likelihood that distributions other than RMDs might be made in the form of partial withdrawals and/or complete surrenders.

- ***The excess of an additional benefit over the amount credited.*** The amount by which an additional benefit exceeds the amount credited to the employee or beneficiary under a contract might affect the probability that the benefit will be paid, and thus could affect the actuarial present value of the benefit. For instance, as described above, (1) a guaranteed minimum income benefit generally provides a stream of annuity payments guaranteed to be at least some minimum amount regardless of the contract's actual cash value, and (2) a guaranteed minimum withdrawal benefit generally provides the right to withdraw a certain specified percentage of contributions for a specified duration regardless of the contract's actual cash value. It might be reasonable to assume that there will be some greater probability that such a benefit will be elected, and thus that the benefit will have greater value, at a time when the amount of the benefit exceeds the cash value under the contract, as compared to when the benefit is less than the cash value under the contract.

- ***Annuitization.*** The APV requirement, by its terms, applies only prior to the date that an annuity contract is annuitized, (i.e., prior to the date annuity payments commence). Some additional benefits, such as certain death benefits, are payable only in the event of death prior to the annuity commencement date. Other benefits, such as a guaranteed minimum income benefit, described above, become payable once the contract is annuitized. Hence, in determining the APV of additional benefits under annuity contracts, it would seem appropriate for an issuer to make some assumptions about whether and when the contracts will be annuitized.

- ***Multiple additional benefits.*** It may be appropriate to make different actuarial assumptions with respect to an additional benefit under a contract depending on whether certain other additional benefits also are provided under the contract. For instance, it might be reasonable to assume that relatively few withdrawals will be made under an annuity contract if it provides a death benefit that is reduced by any distributions from the contract. On the other hand, it might be reasonable to assume greater and more frequent withdrawals will be made under the contract if it provides that same death benefit together with a guaranteed minimum withdrawal benefit.

The APV requirement, by its terms, applies only prior to the date that an annuity contract is annuitized … Some additional benefits, such as certain death benefits, are payable only in the event of death prior to the annuity commencement date.

Conclusion

As discussed above, there is a significant amount of uncertainty on the part of tax practitioners, actuaries and insurance company personnel regarding how to apply the APV requirement. It appears that neither the IRS nor the Treasury Department currently are contemplating issuing any guidance on the subject. Nevertheless, the regulations provide a fair amount of flexibility in applying the APV requirement. There might be a number of different assumptions and methods for computing the actuarial present value of a benefit that are reasonable. Thus, Q&A-12 permits a range of acceptable actuarial present values with respect to a benefit under a deferred annuity contract.

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The formula on page 3 is exact when K is a constant during the entire time horizon over which the TR and TAR difference between the alternatives reverse to zero. The IRR is independent of the reversal time period. It is generally a good approximation even when K is not a constant over that period.

Note the obvious result of the formula on page 3:

- When K=0, the IRR equals I.
- When K =1, the IRR equals the pre-tax investment income rate.
- Similarly, as K approaches (1/R), the IRR becomes very large, since the tax saving approaches the pre-tax strain.
- The tax saving can actually exceed the pre-tax strain on free surplus. In such case, the IRR concept is no longer applicable and the MEV is clearly highly positive without having to go through the above IRR formula.

Importantly, the above IRR formula is *symmetric*. Thus, for example, if TAR is reduced by $1, while tax reserves are reduced by only $.50, then the "borrowing cost" for the temporary initial statutory surplus relief is given by the same formula. Typically, a reduction in a formulaic statutory reserve structure will result in a tax reserve reduction of a lesser amount—a good answer. The reasons are twofold:

- The tax reserve begins from a generally lower base, thus the same percentage decrease results in a lower absolute decrease.

- On the "way down," the tax reserve hits the cash value floor sooner.

If the company can deploy that incremental "Borrowed Capital" at an after-tax return higher than the "Borrowing Cost," it should do so. Thus, in assessing two comparative alternatives, if the IRR or Borrowing Cost is less than the estimated cost of capital (or the returns expected from otherwise deploying surplus), it may be to the entity's advantage to opt for the lower SR alternative.[1]

Illustrative Examples

On page 11 are examples of the IRR calculation. Conversely, this is also the Borrowing Cost if one were to go from Alternative B to Alternative A, gaining an immediate increment to free surplus. Since in these examples SR is set equal to TAR, the term "Book Profit" is used and is synonymous in this case with distributable earnings.

The Book Profit is calculated per the formula shown in the appendix.

Obviously, in Example 3, if the present value of incremental book profit is zero at the 22.54 percent IRR used in the example, the MEV is quite positive at a cost-of-capital rate of 11 percent, for example. The following table illustrates the MEV amount (i.e., + $.81) as a result of the migration from Alternative A to Alternative B at a cost-of-capital rate of 11 percent.

Table 1

Year	Book Profit	Discounted at: 22.54%	11.0%
1	-3.55	(2.90)	(3.20)
2	1.51	1.01	1.23
3	1.35	0.73	0.99
4	1.55	0.69	1.02
5	1.31	0.47	0.78
		0.00	0.81

APPENDIX

Formula Derivation

The "Deltas" are dropped from the terms below, that is:

- i = Investment income rate after tax
- TAR = Increment to statutory total asset requirement
- TR = Increment to tax reserve
- BP = Increment to book profit#

$$BP_t = (TAR_{t-1})*(1+i) + R*(TR_t - TR_{t-1}) - TAR_t$$

Assume that TR = K*(TAR) for all t.

[1] Since TAR usually exceeds SR, in the latter cases further analysis is required if a lower SR simply means a commensurate increase in the TR. In such case, the choice of a lower SR may be inappropriate.

"Book profit" is not a completely appropriate term. If TAR is used instead of statutory reserves, "distributable earnings" should be used in place of book profit. However, the mathematics is the same.

Table 2

Example 1

I = 0.04 Discount
R = 0.35

Illustration: Assume a 5-Year Reversal

					Increment		Incremental Book Profit	
TAR	Alt. A	100		Cal. Year	Stat. TAR	Tax Res	Absolute	PV @ IRR
	Alt. B	120		1	20.00	23.00	(11.95)	(11.20)
	Difference		20	2	16.00	18.40	3.19	2.80
Tax Reserve	Alt. A	70		3	12.00	13.80	3.03	2.49
	Alt. B	93		4	6.00	6.90	4.07	3.14
	Difference		23	5	-	-	3.83	2.77
IRR			6.69% 0.937255					0.00

Example 2

I = 0.04
R = 0.35

					Increment		Incremental Book Profit	
TAR	Alt. A	100		Cal. Year	Stat. TAR	Tax Res	Absolute	PV @ IRR
	Alt. B	120		1	20.00	40.00	(6.00)	(5.29)
	Difference		20	2	16.00	32.00	2.00	1.56
Tax Reserve	Alt. A	70		3	12.00	24.00	1.84	1.26
	Alt. B	110		4	6.00	12.00	2.28	1.38
	Difference		40	5	-	-	2.04	1.09
IRR			13.33% 0.882353					0.00

Example 3

I = 0.04
R = 0.35

					Increment		Incremental Book Profit	
TAR	Alt. A	100		Cal. Year	Stat. TAR	Tax Res	Absolute	PV @ IRR
	Alt. B	120		1	20.00	47.00	(3.55)	(2.90)
	Difference		20	2	16.00	37.60	1.51	1.01
Tax Reserve	Alt. A	70		3	12.00	28.20	1.35	0.73
	Alt. B	117		4	6.00	14.10	1.55	0.69
	Difference		47	5	-	-	1.31	0.47
IRR			22.54% 0.816092					0.00

Then, $BP_t = (TAR_{t-1})*(1+i) + K*R*(TAR_t - TAR_{t-1}) - TAR_t$

$= (TAR_{t-1})*(1+i-K*R) - TAR_t*(1-K*R)$

Multiply through by $\{[1 - K*R]/[1 + i - K*R]\}^t$, and sum from 1 to n. (1)

We get: $PresVal(BP_t) = \sum \{ TAR_{t-1}*[1-K*R]^t/(1+i-K*R)^{t-1} - TAR_t*[1-K*R]^{t+1}/(1+i-K*R)^t \}$ (2)

This is the sum of a difference. It also equals zero, since $TAR_{t-1} = 0$ at t=1, and $TAR_n = 0$.

The formula (1) expression represents a discount factor, i.e., $[1/(1+IRR)]^t$.

Thus, at t=1, $(1-K*R)/(1+i-K*R) = 1/(1+IRR)$.

$IRR = i/(1-K*R)$[2] QED

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[2] For a more in-depth discussion of this formula, see "Internal Rate of Return as an Evaluator of Tax Planning Strategies," Transactions of Society of Actuaries, Vol 44 (Edward L. Robbins and Kenneth A. LaSorella), 1993.

T³: *Taxing Times* Tidbits

In-House Tax Advisors and Actuaries Beware on Product Taxation

by Peter H. Winslow and Susan J. Hotine

On June 20, 2005, new and more stringent standards of practice went into effect under IRS Circular 230 for tax consultants (lawyers, accountants and possibly actuaries) who practice before the IRS and provide tax advice. To oversimplify matters, any written tax advice (including electronic communications) that is intended to be relied upon to avoid penalties or is intended to be used in marketing, must rise to the status of a formal written opinion, that considers all the relevant facts and federal tax issues. Any tax advice that falls short of a formal opinion that reaches a confidence level of more likely than not on all significant tax issues must prominently state something like the following:

> "This document does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the document. With respect to those significant Federal tax issues, this document was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."

In addition, if the tax consultant understands that the tax advice may be used in marketing, IRS Circular 230 requires that the document disclose any compensation arrangement between the tax consultant and the promoter, indicate that it was written to support marketing and recommend that the taxpayer seek advice from an independent tax advisor.

Generally, tax advice given by an in-house tax advisor is not subject to these rules to the extent the tax advisor is providing the advice in his/her capacity as an employee solely for purposes of determining his/her employer's tax liability. Importantly, however, there is no exception for tax advice from in-house tax professionals that addresses the tax treatment of customers. Likewise, there is no exception for "customer" tax advice based on whether or not the tax advice is used internally or in marketing materials.

An issue has been raised whether anyone who gives an "opinion" covering federal tax issues in connection with an arrangement or plan that has a significant tax avoidance purpose is deemed to be practicing before the IRS, whether or not that person is a lawyer or accountant. Does the circular apply, for example, to an in-house or consulting actuary when he/she prepares a written analysis of IRC §7702 compliance that is intended to be used exclusively within the company? At least one IRS representative has said that the IRS Circular 230 requirements only apply to lawyers, accountants, enrolled agents and, in some cases, enrolled actuaries [as listed in section 10.2(e)]. Other IRS officials and commentators have disagreed, however. Even if it applies, it is unclear what sanction could be imposed on an actuary's non-compliance if the actuary never practices before the IRS. Therefore, concern over whether the IRS Circular 230 requirements apply to an actuary's work product may be more theoretical than practical.

As a result of the newly effective provisions of IRS Circular 230, life insurance companies should review their marketing materials and actuaries should review their current internal practices to determine whether they are in compliance and, if not, whether the appropriate disclosure or disclaimer language should be added to written tax materials.

The IRS Goes Paperless – Notice 2005-35

by Brian G. King

Those who have been involved with IRS filings to remediate inadvertent modified endowment contracts (MECs) or failed life insurance contracts know that the filing requirements can be onerous. Taxpayers are required to file paper reports at a contract level, generating between one and four (or more) pages per contract, resulting in recent submissions that have exceeded 10,000 pages! With the recent issuance of Revenue Ruling 2005-6 providing guidance on the treatment of qualified addition benefits (QAB) under IRC §7702 and §7702A, the IRS became aware of the likelihood that taxpayers would be filing submissions including policy number listings in the hundreds of thousands.

Revenue Ruling 2005-6 provides that for purposes of determining whether a contract qualifies as life insurance under IRC §7702, and as a MEC under IRC §7702A, charges for QABs must be taken into account under the expense charge rule of IRC §7702(c)(3)(B)(ii). The revenue ruling provides three alternatives to companies whose compliance systems do not currently account for charges for QABs under the expense charge rule of IRC §7702(c)(3)(B)(ii). Under Aternatives B and C of the ruling, a company may request relief in the form of a closing agreement under which the contracts will not be treated as having failed the requirements of IRC §7702(a) or as a MEC under IRC §7702A by reason of improperly accounting for charges for existing QABs. The company's request for a closing agreement must include a list identifying the contracts for which relief is requested.

According to Notice 2005-35, the IRS is aware that for certain taxpayers, a list identifying the contracts subject to the closing agreement may be sufficiently large that it could be burdensome for the taxpayer to provide the list on paper. In response to this concern, the IRS is allowing taxpayers to submit the list electronically. Taxpayers must provide three files in read-only format, each file must be on either a CD-ROM or diskette and the files must be in Adobe portable document format (other formats are acceptable provided the IRS has preapproved the format). Let's hope that the electronic filing under this notice is successful in the eyes of the IRS and opens the door for electronic submissions for other IRC §7702 and IRC §7702A closing agreements as well.

IRS Attempts to Avoid Income/Deduction Mismatch for Deferred and Uncollected Premiums

by Peter H. Winslow and Susan J. Hotine

In CCA 200504030 (Oct. 15, 2004), the IRS Chief Counsel adopted the position that a change in computing life insurance reserves to remove net deferred and uncollected premiums (D&U premiums) is a change in method of accounting rather than a change in basis of computing life insurance reserves. This conclusion had significant economic and practical consequences to the taxpayer in the CCA. If the correction for D&U premiums is considered to be a change in method of accounting, IRC §446(e) provides that securing the Commissioner's consent is a condition to the change. The consent requirement applies even though the failure to back out D&U premiums is erroneous. Another consequence of characterizing the D&U premium change as a change in method of accounting is that IRC §481 requires an adjustment to prevent a double deduction or a double inclusion of income that otherwise would result from the change. A change to reduce reserves for D&U premiums will result in a double deduction for reserves in an amount equal to the opening balance of D&U premiums for the year of the change. Therefore, an unfavorable IRC §481 adjustment, increasing taxable income in an amount equal to such opening balance of D&U premiums, will be required, and such amount at best will be spread over four years. Rev. Proc. 97-27, 1997-1 C.B. 680, modified by Rev. Proc. 2002-19, 2002-1 C.B. 696. On the other hand, if the D&U premium change qualifies as a change in basis of computing reserves from an erroneous reserve method to the reserve method authorized by the Code, no permission from the IRS is needed and the adverse adjustment to eliminate the double deduction arising from the change is spread over 10 years under IRC §807(f). Rev. Rul. 94-74, 1994-2 C.B. 157. Therefore, in these circumstances, there is a significant advantage if IRC §807(f) applies and a 10-year spread is allowable.

At first blush, it may appear that the IRS Chief Counsel is wrong; the reduction in reserves for D&U premiums seems to be a change in basis of computing reserves to which IRC §807(f) applies.

However, it is not that simple. The requirement in the statute for reducing reserves for D&U premiums is found in IRC §811(c)(1), which provides that no reserve can be established for any item unless the gross amount of premiums attributable to the item is required to be included in life insurance gross income. Because IRC §811(a) adopts an accrual method of accounting for premiums, and D&U premiums usually are not accrued, they are not required to be included in life insurance gross income. Therefore, D&U premiums should be excluded from both premiums and, as a result, also excluded from reserves. A correction in timing for reporting premium income is a change in method of accounting requiring the consent of the Commissioner under IRC §446(e). So, the issue becomes: Is the reserve correction for D&U premiums a change in method of accounting because it is driven in the first instance by the treatment of an income item? Or, is the D&U premium income and the resulting reserve effects treated as two separate items subject to different change rules?

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The taxpayer in the CCA adopted a literal reading of the statute and treated the change in the income item and the resulting change in the reserve treatment as two separate items. First, it corrected the reserves by eliminating D&U premiums. It did so without seeking the Commissioner's consent as authorized by Rev. Rul. 94-74. The taxpayer presumably then followed the rules of IRC §807(f) and spread the adverse adjustment resulting from the change over 10 years. On the premium side, the taxpayer treated the correction as a change in method of accounting by filing a Form 3115 seeking the IRS' consent. The taxpayer probably sought to take the favorable IRC §481 adjustment to eliminate the double inclusion of D&U premiums, which would otherwise be caused by the accounting method change, all in one year under Rev. Proc. 2002-19. The combined result of a favorable IRC §481 adjustment and the spread of the unfavorable IRC §807(f) amount was unacceptable to IRS Chief Counsel.

The Chief Counsel's solution to avoid the mismatch of the one-year favorable IRC §481 adjustment and the 10-year spread of the unfavorable IRC §807(f) amount was to say, without analysis, that the reserve change for D&U premiums is a change in method of accounting requiring the Commissioner's consent. Although the Chief Counsel's position is understandable, questions might be raised with respect to that position and the technical analysis (or lack thereof) supporting it. IRC §811(c)(1) mandates that a reserve not be established with respect to an item when premiums attributable to that item are not "required" to be included in income; by its terms, then, if premiums are erroneously included in income, but not "required" to be so included, a taxpayer is not permitted to establish a reserve for the item to which those erroneously included premiums relate. Thus, except to the extent that the inclusion of the D&U premiums was required (i.e., except to the extent those premiums were accrued), the taxpayer was computing its reserves with respect to the D&U premiums incorrectly. What if the taxpayer had not sought a change in method of accounting for the income inclusion of D&U premiums? Is the taxpayer supposed to remain on what IRC §811(c)(1) indicates is an incorrect method for computing reserves? Or, based on the literal wording of IRC §811(c)(1), could the IRS require a change in basis of computing reserves on audit? If the IRS tried to force a reserve change to the correct method, can the IRS require an accounting method change for the income inclusion of the D&U premiums? Given its published position in Rev. Proc. 97-27, 1997-1 C.B. 680, as modified by Rev. Proc. 2002-19, 2002-1 C.B. 696, is there any way for the IRS to impose a 10-year spread of the favorable IRC §481 adjustment for premiums to match the IRC §807(f) 10-year spread? Probably not, if the premium income and reserve computation changes are treated as two separate items.

The Chief Counsel's solution, without analysis and ignoring these kinds of questions, is to call "it" a change in method of accounting. The Chief Counsel appears to have concluded that the offsetting premium income and reserve adjustments are a single item for accounting purposes and, therefore, IRC §807(f) never enters into the equation. Arguably, this is a strained application of accounting method change provisions (including IRC §807(f)) in light of the language of IRC §811(c)(1). Perhaps that is the best the Chief Counsel could do under the circumstances.

Companion IRC §7702 and 7702A Closing Agreements Can Reduce Toll Charges

by Stephen P. Dicke

Typically, when an insurer seeks a closing agreement from the IRS to correct "failures" of a life insurance contract to meet the prefunding limits under IRC §7702 (for tax qualification as a life insurance contract) or IRC §7702A (to avoid adverse tax status as a modified endowment contract or MEC), the IRS will require a separate closing agreement for §7702 failures and another separate closing agreement for §7702A failures. Each closing agreement will require a separate "toll charge" to be paid by the insurer to the IRS for the correction, and generally this toll charge will be based on some measure (or part) of the "income on the contract" or earnings for each corrected policy.

More recently, some insurers have asked the IRS to allow simultaneous corrections in the same policies to correct both §7702 and §7702A failures, e.g., by making one refund of "excess" premium from each policy that is sufficient to correct both its §7702 and its §7702A failures at the same time. Such simultaneous corrections not only can save administrative costs for the insurer, but also could lead to a reduction in the total amount of toll charges payable to the IRS. The IRS continues to require separate closing agreements for such simultaneous §7702 and §7702A corrections. However, the IRS is now willing under certain circumstances to allow a reduction in the combined toll charges for "companion" §7702 and §7702A closing agreements with the same insurer, to the extent that these "companion" closing

agreements cover the same policies. Such a reduction in the combined toll charges may be allowed in the form of a credit or offset against the toll charge due in the second closing agreement, to reflect some portion of the toll charge that is being paid with the first closing agreement.

The question in the TAM was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with MGDBs that were issued before the adoption of NAIC AG34.

IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date

by Peter H. Winslow and Susan J. Hotine

In general, tax reserves qualifying as life insurance reserves are required to be computed under IRC §807(d) and related IRC sections by starting with statutory reserves as computed in the NAIC Annual Statement and then making six adjustments:

1) Use of the tax reserve method prescribed by the NAIC (CRVM for life insurance or CARVM for annuities) as of the issue date;

2) Substitution of the applicable federal interest rate in effect as of the issue date for the statutory rate;

3) Substitution of standard mortality or morbidity tables prevailing in 26 states as of the issue date;

4) Reduction for net deferred and uncollected premiums;

5) Reduction for benefits attributable to excess interest guarantees beyond the end of the taxable year; and

6) Elimination of deficiency reserves.

These actuarially computed tax reserves are then subject to a statutory reserve cap and a net surrender value floor with the cap and floor applied on a contract-by-contract basis.

In TAM 200448046 (Nov. 26, 2004), the IRS addressed a situation where, at the time variable annuity contracts with minimum guaranteed death benefits (MGDBs) were issued, the NAIC had no clear guidance as to how the Commissioner's Annuity Reserve Valuation Method (CARVM) applied to the MGDBs. The legislative history sets forth general rules to resolve cases like this where there are varying interpretations of CARVM as of the issue date. First, as of the date of issue of a contract, the taxpayer is required to use the method prescribed by the NAIC and take into account any factors recommended by the NAIC for such contracts; factors to be taken into account are generally addressed in actuarial guidelines (AG) issued by the NAIC. Second, where no NAIC AG exists, or for contracts issued prior to the NAIC's adoption of a guideline, taxpayers are to look to the prevailing interpretation of the Standard Valuation Law, i.e., the interpretation that has been adopted by at least 26 states. Absent an NAIC guideline or a prevailing interpretation of the states, the tax reserve method should follow the interpretation used by the taxpayer for its statutory reserves as long as the statutory method is one of several permissible interpretations of the SVL as of the issue date. This is because, except for the six federally prescribed items outlined above, tax reserve assumptions are required to be the same as those used for statutory reserves.

In TAM 200448046, the IRS purported to follow these rules set forth in the legislative history, but it is questionable whether it did so properly. The question in the TAM was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with MGDBs that were issued before the adoption of NAIC AG 34. For statutory purposes, the taxpayer had used the method required by the Connecticut Insurance Department which, for purposes of computing the MGDB reserves reported in the Annual Statement, required an assumption of a one-third drop in asset value. The Connecticut asset-drop assumption was not required by any other state as of the issue date of the contracts and resulted in greater reserves than were required under the AG 34 method that subsequently was adopted.

Before the adoption of AG 34, it was unclear how to reserve for MGDBs. Some companies held separate reserves computed as if the net amount currently at risk were a separate life insurance contract subject to

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Commissioner's Reserve Valuation Method (CRVM). Others held no additional reserves on the theory that the MGDBs did not provide the stream of benefits that yielded the greatest present value as compared to other benefits. A few companies computed MGDB reserves assuming some type of asset-drop. In light of this wide range of practices, the authors are unaware of a prevailing state interpretation of CARVM prior to the adoption of AG 34. Under these circumstances, the taxpayer should have been required to use the Connecticut-imposed reserve method on the Annual Statement. The reserve method was merely one of many permissible interpretations and there was no NAIC guideline or prevailing state interpretation in effect that addressed the issue of reserving for MGDBs.

TAM 200448046 reaches a different conclusion, however. Instead of attempting to determine whether there was a prevailing state interpretation of how CARVM applied with respect to MGDBs, the IRS concluded that the taxpayer could not use the Connecticut method because at least 26 states permitted smaller reserves for MGDBs. In its analysis, the TAM appears to have injected two new principles into determining what is a prevailing state interpretation—principles that do not appear in the statute or the legislative history. First, implicit in the TAM's reasoning is that a prevailing view of the states can be gleaned from passive acceptance by state regulators of CARVM interpretations made by companies filing Annual Statements. Second and more importantly, the TAM's reasoning interposes a minimum reserve requirement on the prevailing-state-interpretation standard of how CARVM should be applied when an item is not addressed directly by the NAIC. That is, even though there was no single prevailing state interpretation of CARVM with respect to the treatment of an item (e.g., MGDBs), and even though a majority of states viewed several interpretations of CARVM as permissible, the TAM concludes that reserves must be computed using the method that yields the smallest reserve permitted by at least 26 states. The TAM gives no guidance as to what interpretation of CARVM this may have been for MGDBs before the adoption of AG 34.

The TAM's analysis is questionable and in apparent conflict with the legislative history's discussion of a company's permitted use of either continuous or curtate functions in computing CRVM reserves. A majority of states permit either assumption; yet the legislative history suggests that the assumption used for statutory reserves governs. In these circumstances, there is no requirement to use curtate functions because they are permitted to be used by 26 states and their use may yield the smallest reserve. In other words, in determining whether there is a prevailing state interpretation of the Standard Valuation Law, the focus is supposed to be on whether the states have adopted a single view as to what is the proper interpretation of CRVM or CARVM, and not on whether there is one of several permissible interpretations yielding the smallest reserve that at least 26 states allow. Lacking a prevailing state interpretation for applying CARVM to MGDBs, in TAM 200448046 the IRS appears to have adopted a new standard that an assumption for computing reserves is not "permissible" unless it has been adopted by 26 states and yields the minimum reserve that can be held for the benefit. Such a position is not prescribed by the statute and is contrary to explanations of the tax reserve provisions in the legislative history. ◀

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New Deferred Compensation Rules Require Immediate Action

by David H. Phillips and Donald R. Saxon

Legislation imposing new restrictions on a wide range of compensation arrangements was signed into law on October 22, 2004. The American Jobs Creation Act (AJCA) adds a new section 409A to the Internal Revenue Code, which imposes restrictions on funding, distributions, and elections to participate in nonqualified deferred compensation plans. While IRS guidance (IRS Notice 2005-1) provides some generous transitional relief, immediate changes will be necessary for many deferred compensation arrangements.

Who is Subject to Section 409A?

The new section 409A covers a broad spectrum of arrangements, including existing plans and some or all of the contributions previously made to them. By its terms, section 409A applies only to amounts deferred pursuant to a "nonqualified deferred compensation plan," on or after Jan. 1, 2005. Any arrangement which postpones payment of compensation to another year, has the potential to be a nonqualified deferred compensation plan. Notice 2005-1, the only IRS guidance relative to section 409A issued at the time this article went to publication, confirmed that the term was intended to include arrangements covering only one person, severance agreements, Supplemental Executive Retirement Plans (SERPs), "defined benefit" nonqualified plans, and arrangements with non-employees (*e.g., directors and trustees*). The statute identifies very few exceptions, the most significant of which are qualified plans, time-off plans and certain stock option arrangements.

> For example, an agreement with a departing executive to pro-rate payment of her severance package over the next 24 months will fall within the scope of the new Section 409A.

While the new law is nominally limited to amounts deferred on or after Jan. 1, 2005, the enabling legislation and the IRS's method of determining when compensation is deemed to be deferred will effectively broaden this application. AJCA, but not section 409A proper, provides that any amounts deferred pursuant to a nonqualified deferred compensation plan that is "materially modified" after Oct. 3, 2004 will be subject to section 409A, regardless of the date of actual deferral. While a material modification does not include an amendment made to comply with section 409A, it would include the enhancement or addition of a benefit or right. In addition, amounts which had not vested prior to section 409A's effective date are deemed to have been contributed on the date they vest, thus making them subject to section 409A.

What Restrictions Does Section 409A Impose?

Section 409A provides that unless the requirements identified below are both included in the plan and enforced, all compensation deferred into a nonqualified deferred compensation plan will be subject to immediate taxation, plus interest (at the general late-payment rate plus 1 percent) back to the date the compensation was deferred, plus a penalty of 20 percent of the deferred compensation. The requirements fall into three categories: distributions, deferral elections and funding.

Distributions. Section 409A permits deferred compensation to be distributed only upon the earliest of: (1) separation from service (but key employees of publicly traded companies must wait an additional six months), (2) disability (as defined in the statute), (3) death, (4) unforeseeable emergency (which is not the equivalent of a 401(k) plan "hardship" and which has not yet been defined by the IRS) and (5) a date irrevocably designated at the time of the deferral elections. Neither the "irrevocable" dates nor the form of distribution (e.g., monthly installments over a fixed period of years) may be accelerated once elected. The "irrevocable date" may be postponed, but only if such postponement is made at least 12 months prior to such date and the new distribution date is at least five years after the original date.

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> For Example, as part of her initial election to participate in her employer's nonqualified deferred compensation plan, Employee A elects to receive a $10,000 distribution on Mar. 31, 2007. Absent the occurrence of one of the other distributable events described above, that $10,000 payment may be made no earlier than Mar. 31, 2007. However, the plan may permit Employee A to elect, before Mar. 31, 2006 (more than 12 months prior to the distribution date) to postpone this $10,000 payment to any date on or after Mar. 31, 2012 (five years from the originally scheduled date of distribution).

It is clear from the legislative history of AJCA that Congress anticipated that all nonqualified deferred compensation plans either already did require, or would interpret section 409A as requiring that participants elect both the time and form of distribution simultaneously with their election to participate. Notice 2005-1 maintains this assumption. However, not only do many nonqualified deferred compensation arrangements have no such provisions, but section 409A contains no such requirement. The unfortunate result is that neither the statute nor Notice 2005-1 offers much guidance as to how the prohibition against changing one's election applies when no previous election has been made.

Deferral elections. The general rule of section 409A is that compensation may be deferred to a nonqualified deferred compensation plan only if the election to defer such compensation is made prior to the taxable year in which the compensation is earned. Two significant exceptions are made, however. First, a newly eligible employee may elect to defer compensation which would have been paid during the year of the election, as long as such election is made within 30 days of the date the employee was first eligible to participate and before the performance of the services which generate the compensation to be deferred. Second, in the case of "performance-based compensation," which Notice 2005-1 refers to as "bonus compensation," for which the relevant performance period is 12 months or more, the election to defer such compensation may be made until six months before the end of the period. Although not directed to do so by section 409A or AJCA, the IRS, in Notice 2005-1, provided a fairly restrictive definition of bonus compensation, and went on to indicate that this definition would be further restricted in the future.

Notice 2005-1 limits bonus compensation—and therefore "performance based compensation"—to compensation, the payment of which is contingent on the satisfaction of performance criteria which are not substantially certain to be met at the time a deferral election is permitted. The criteria may be subjective, but only if they relate to the performance of the participant (either individually or as part of a group or business unit), and the determination that the criteria have been met is not made by the participant or a family member. While this latter requirement sounds reasonable, participation in nonqualified deferred compensation plans is essentially limited to the types of persons who make such subjective determinations. In a small organization, it may not be possible to classify some bonuses as performance based compensation for section 409A purposes.

Funding. Section 409A does not, as some earlier proposed legislation attempted to do, prohibit the use of so-called Rabbi Trusts. Rabbi Trusts are funding vehicles for nonqualified deferred compensation plans which protect such a plan's assets from use by the employer, unless and until the employer becomes insolvent, at which time the Rabbi Trust's assets are subject to the claims of the employer's creditors. Though permitting their continued use, Section 409A does limit Rabbi Trusts in two ways. First, neither the Rabbi Trust nor its assets may be located outside the United States. Second, the Rabbi Trust may not contain any provisions, which purport to place the rights of participants ahead of the rights of general creditors upon a change in the financial health of the employer.

Transition to the New Rules

A prerequisite for the transitional relief included in Notice 2005-1 is that the plan be operated in good faith compliance with existing guidance and the current terms of the plan itself—to the extent not in conflict with the guidance—until the plan document is actually amended (see below). This means that the plan must immediately begin to operate in accordance with section 409A, even if this conflicts with the written terms of the plan.

For some plans, because pre-2005 deferrals are not necessarily subject to the new rules, the only immediate impact will be on the solicitation of participant elections. As noted above, section 409A requires these elections to be made prior to the relevant year. Of course, this means that the elections to defer 2005 compensation must have been made during 2004. Because the IRS did not publish Notice 2005-1 until Dec. 20, 2004, and then amended it Jan. 6, 2005, the Notice included a

grace period for implementation of these election rules. Plans already in existence in 2004 could permit—if not inconsistent with the plans' current provisions—participants to make elections relative to their 2005 compensation as late as Mar. 15, 2005, provided the election was made before the amounts were earned.

Notice 2005-1 also contains some very generous transitional rules for current participants in existing nonqualified deferred compensation plans. It allows a plan that was in existence prior to 2005 to be amended to permit participants, during 2005 only, to terminate participation in the plan, to cancel an earlier deferral election, to reduce the amount of an earlier deferral election or to elect a new form of distribution or new payment option. Further, if a participant elects to terminate participation, the plan may permit that participant's account to be distributed immediately, as long as it is immediately taxable to the participant (but without triggering the interest or penalty provisions). Similarly, if a previous election is reduced or cancelled, any previously deferred compensation, no longer subject to the election, may be returned and is immediately taxable.

The Notice does not indicate whether this election to terminate participation must be permanent, precluding any future contributions. While it would seem logical to exclude a participant who elects to terminate participation under this provision from deferring any 2005 compensation, this is not expressly required. The Notice also fails to identify whether the transitional right to elect a new form of distribution or payment option may be used to elect an option not previously available under the plan, but which has been added in 2005.

While these rules may ease the transition from pre-AJCA to post-AJCA nonqualified plan participation, arguably an amendment to utilize these rules would be a material modification, causing the entire plan and all previously deferred amounts to become subject to section 409A.

Fortunately, the IRS has acknowledged that more specific guidance and more time are required before sponsors of nonqualified deferred compensation plans can reasonably be expected to fully comply with section 409A. Therefore, formal amendment of nonconforming deferred compensation plans may be postponed until the end of 2005, as long as the plan is operated, in the interim, in "good faith" compliance with the provisions of section 409A and the Notice.

The Notice also fails to identify whether the transitional right to elect a new form of distribution or payment option may be used to elect an option not previously available under the plan ...

By the end of 2005, every deferred compensation plan subject to section 409A must be amended, even if only to formalize existing procedure, or conform terminology to the language of the new law. Also, by this same date, administrators of these plans must be prepared to implement the new distribution rules for amounts deferred in 2005 or later. In some cases, this may require that different portions of a participant's accumulated deferred compensation be handled in distinctly different manners. An administrator will want to ensure that the plan's recordkeeping and documentation process is prepared for this possibility.

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New Proposed Regulations on "Attained Age" Under IRC Section 7702

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

On May 24, 2005, the Treasury Department and Internal Revenue Service published a notice of proposed rulemaking (the "Notice") proposing regulations under Internal Revenue Code §7702, the federal tax definition of a "life insurance contract." The proposed regulations explain how to determine the attained age of an insured for purposes of testing whether a contract satisfies the requirements of §7702. In addition to addressing contracts covering a single insured's life, the proposed regulations address the permissible attained age assumptions that may be used under joint life insurance contracts, both first-to-die contracts and last-to-die contracts. As discussed further below, the proposed regulations would apply to contracts issued on or after the date that is one year after the regulations are published as final regulations in the Federal Register.

An insured's attained age is relevant in a number of contexts under §7702, and by cross reference under §7702A, the Code's definition of a "modified endowment contract." In general, the computation of guideline premiums and net single premiums under §7702 and 7-pay premiums under §7702A at any given time requires knowledge of, or an assumption as to, the age(s) of the insured(s) at that time. More particularly, §7702(e)(1)(B) generally provides that the calculations under §7702 must assume that a contract's maturity date is no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100. Also, under §7702(e)(1)(C), death benefits are deemed to be provided until this maturity date, and under §7702(e)(1)(D), the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date) is deemed not to exceed the least amount payable as a death benefit at any time under the contract. The insured's attained age also is pertinent to application of the "cash value corridor" requirement of §7702(d), which must be satisfied by contracts intending to comply with the guideline premium limitation.

Rules for attained age. The proposed regulations, which are relatively brief for income tax regulations, begin by establishing a general rule for determining an insured's attained age for purposes of the guideline premium requirements of §7702(c), the cash value corridor of §7702(d), and the computational rules of §7702(e)—which apply to the cash value accumulation test as well, and derivatively, to the §7702A 7-pay premiums. Specifically, the proposed regulations provide that the attained age of the insured under a contract insuring a single life is either: (1) the insured's age determined by reference to the individual's actual birthday as of the date of determination (actual age), or (2) the insured's age determined by reference to contract anniversary (rather than the insured's actual birthday)—sometimes called the "insurance age"—so long as the age assumed under the contract is within 12 months of the actual age. Under these rules, which thus far track statements in the legislative history of §7702 (as noted further below), age-last-birthday and age-nearest-birthday assumptions continue to be permitted. In addition, the proposed regulations require, presumably to preclude any whipsaw effect, that whichever attained age is used for a given contract must be used consistently for purposes of §7702(c), §7702(d) and §7702(e), as applicable.

This same set of requirements also applies for purposes of determining an insured's attained age in the case of contracts covering multiple lives, although with significant exceptions. Specifically, the proposed regulations provide that:

(i) The attained age of the insured under a contract insuring multiple lives on a last-to-die basis—joint and last survivor contracts—is the attained age of the youngest insured.

(ii) The attained age of the insured under a contract insuring multiple lives on a first-to-die basis is the attained age of the oldest insured.

These rules for joint life contracts, as recognized by the government in the preamble to the proposed regulations (which explains the background of and reasons for the

proposal), are without legal precedent and may well run counter to the practices adopted by many insurers. In the case of last-to-die contracts, some insurers have been following rule (i) for a considerable period of time, while others have made use of a joint equal age methodology (discussed below). In the case of first-to-die contracts, it is doubtful that any insurer has followed rule (ii), although application of the rule may not present a problem as a practical matter. If the guideline published by the National Association of Insurance Commissioners (Actuarial Guideline XX) for determining the joint equal age for such contracts is adhered to, it appears that only a very limited group of contracts (depending upon the gender and age relationship of the insureds) would fall on the wrong side of rule (ii). These rules apply regardless of the gender of the insureds or the presence of any smoker or substandard rating applicable to one of them.

Relationship of the proposed regulations to the reasonable mortality charge requirement: The question of joint equal age mortality. Interestingly, the preamble to the proposed regulations disclaims any relationship between the new rules for multiple life contracts and the so-called "reasonable mortality charge" requirement of §7702(c)(3)(B)(i) introduced by TAMRA in 1988. Specifically, the preamble states that the proposed regulations "are not intended to specify which multiple-life actuarial methodologies are appropriate to determine reasonable mortality charges under §7702 and §7702A, or how any such methodology should be applied." Hence, while the proposed rules preclude the use of joint equal age assumptions with respect to deemed maturity dates for purposes of §7702(e), in the passage just quoted the government seemingly indicates a desire not to address in these rules the appropriateness of mortality charges based on joint equal age assumptions under §7702(c)(3)(B)(i).

What is unclear, however, is whether the practical effect of the proposed regulations will be to preclude the use of joint equal age mortality once the regulations become effective. Consider, for example, a second-to-die life insurance contract under which the joint equal age of the insureds at issue is 60, but the age of the younger insured at that time is 53. In this case, the proposed regulations would require use of a deemed maturity date (assuming the younger insured's age 100 is used) in the 47th policy year. In contrast, the use of mortality based on a joint equal age assumption would place the contract's deemed maturity date—when the joint equal age is 100 years—on the 40th policy anniversary, when the younger insured in the example is only 93 years of age. Thus, the use of joint equal age mortality would seem to have the effect of assuming a maturity date prior to the time permitted by the proposed regulations. It also is unclear what adjustments to a joint-equal-age-based mortality assumption might be appropriate to eliminate this apparent problem. If the proposed regulations become effective in their current form, insurers may find it difficult, or even impossible, to apply a joint equal age mortality assumption (at least for certain combinations of insureds) for contracts which the new rules govern.

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Relationship of the proposed regulations to the 2001 CSO tables. Last year, the IRS issued Notice 2004-61, 2004-41 I.R.B. 596 (Oct. 12, 2004), which addressed transition issues relating to the newly prevailing 2001 CSO mortality tables. This IRS notice did not comment on one aspect of the 2001 CSO tables—the relationship between the requirement of §7702 that a deemed maturity date between age 95 and 100 must be used and the fact that the new tables extend to age 121. The proposed regulations on attained age similarly do not speak to this aspect of the new tables. The preamble to the proposed regulations does state that "[t]he deemed maturity date generally is the [termination] date set forth in the contract or the end of the mortality table (which, when §7702 was enacted in 1984, was age 100)." Presumably, the word "generally" was used to reflect the fact that some contracts will need to use a deemed maturity date for §7702 purposes that differs from the termination date set forth in the contract or the end of the mortality table. For example, a contract with guaranteed mortality based on the 2001 CSO tables and a stated termination date of age 121 will nonetheless need to use age 100 as the deemed maturity date because of the computational rule of §7702(e)(1)(B).

Consistency rule. As noted above, the proposed regulations contain a consistency requirement. Specifically, section 1.7702-3(b)(2) of the proposed regulations requires that "whichever attained age is used with respect to a contract must be used consistently from year to year and consistently for purposes of §7702(c), §7702(d), and §7702(e), as applicable." While the promulgation of such a requirement is understandable, its scope is unclear in a number of respects.

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Segment-based methodology. One common practice among insurers is to treat increases in coverage as a new date of issue with respect to the increase and to treat decreases in coverage as eliminating either the most recent coverage increases or a *pro rata* portion of all prior coverages. This practice often is followed when the computer-based administrative system creates an at-issue coverage segment and then a new segment for each increase in coverage. Under this segment-based methodology, when the insurer calculates the attained-age decrement in respect of a coverage decrease, it typically will look to the attained age applicable to each coverage that is being decreased.

To illustrate this practice, assume that a contract was issued on Jan. 1, 2000 with a $100,000 face amount, the insurer applies an age nearest birthday assumption, and on Sept. 1, 1999 the insured turned age 35. Thus, at issue, the insured will be considered age 35 with respect to the $100,000 of coverage. Assume also that on May 1, 2005, coverage is increased by $50,000. Here, using a segment-based approach, the insurer may consider the increase as a new date of issue with respect to the increase, so that the insured will be considered age 41 for purposes of calculating the attained age increment to the guideline premiums, even though the increase occurs during the policy year when the insured is otherwise considered age 40. (Other insurers may focus instead on the policy year during which the increase occurs, and thus treat the insured as age 40 with respect to the increase.) If on May 1, 2006, coverage is decreased by $60,000, the insurer, following the segment-based approach, may treat this as a reduction of the entire $50,000 increase made a year earlier, thus reflecting an attained age of 42 with respect to this portion of the attained-age decrement to be calculated, and as a $10,000 reduction of the initial face amount, thus reflecting an attained age of 41 with respect to this remaining portion of the attained-age decrement to be calculated. On the other hand, an insurer applying a *pro rata* approach would view $100,000/$150,000, or 2/3, of the decrease as attributable to the initial face amount and $50,000/$150,000, or 1/3, of the decrease as attributable to the coverage increase in the prior year. (Insurers focusing on the policy year would assume that the insured is age 41 with respect to the decrease, since the insured is considered that age for the policy year during which the reduction occurred.)

The preamble to the proposed regulations refers to the Senate Finance Committee explanation of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, which states in part that "the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age." Significantly for the segment-based approach, the Finance Committee explanation goes on to state that when there is a change in the benefits under a contract, "the date of change for increased benefits should be treated as a new date [of issue] with respect to the changed portion of the contract." This passage may be read as providing explicit support for the segment-based approach that many insurers have applied.

Ultimately, each of the practices described above should be viewed by the IRS as in conformity with the consistency rule in the proposed regulations, although it would be useful if this were clarified. In many cases, the approach adopted is deeply embedded in the computer-based administration system that monitors contracts' compliance with §7702 and §7702A, and thus any contrary view could present significant difficulties for insurers.

§7702(c) vs. §7702(d). Another question that has been raised is whether the consistency rule requires use of the same assumption for purposes of calculating guideline premiums and applying the cash value corridor. Seemingly, this should not be necessary as long as the age assumption used with respect to each of these respective requirements is consistently applied.

Contractual assumptions. A further question is whether age assumptions contained within a contract (used, for example, for purposes of determining guaranteed mortality charges) must be used under §7702, e.g., if a contract sets forth mortality guarantees based on an age-last-birthday assumption, is it permissible to calculate guideline premiums using an age-nearest-birthday assumption? Generally speaking, where §7702 does not prescribe a particular treatment for an aspect of the calculations, it is appropriate to follow the mechanics of a contract, since such a practice usually will be actuarially reasonable in the circumstance. The statute does not, however, expressly require this, and thus the extent to which variations in practice are permitted is unclear in some respects. We observe that the second example of section 1.7702-3(e) of the proposed regulations describes use of an age-nearest-birthday assumption and notes that "under the contract" premiums were determined on this basis. In addition, one of the safe harbors with respect to the reasonable mortality charge rule set forth in Notice 2004-61 limits the charges that can be reflected under

§7702 to those guaranteed under the contract, and thus insurers intending to utilize this safe harbor generally will need to reflect contractual age assumptions in their guideline premium calculations.

The scope of the consistency requirement is unclear at present, and there may well be other common practices that could raise questions.

Effective date. The proposed regulations, as previously noted, generally would apply to contracts issued on or after the date that is one year after the regulations are published as final regulations in the Federal Register. The proposed regulations provide, however, that a taxpayer may elect to apply the proposed regulations retroactively for contracts issued earlier, so long as the taxpayer does not later determine qualification of those contracts in a manner that is inconsistent with the proposed regulations.

Given the general prospective application of the regulations' guidance, questions have been asked about the appropriateness of practices, such as joint equal age assumptions and age rate-ups, that insurers have used and continue to use with respect to contracts not subject to the requirements of the Notice, i.e., contracts issued before the above described effective date. Technically, the regulations do not in any way address such contracts or the appropriateness of any particular practices applied to determine their compliance (apart from the effective date rule permitting a taxpayer to apply the guidance retroactively to such contracts). Thus, the appropriateness of any particular interpretation of §7702 and associated practice must be determined based on the requirements as set forth in the statute and other authorities such as legislative histories pertinent to such requirements. They must be judged, in other words, based on the law as it exists without regard to the proposed regulations.

While the proposed regulations thus do not provide any comfort with respect to prior and existing practices (unlike, for example, the relief provided in Rev. Rul. 2005-6 with respect to the treatment of qualified additional benefits), it can fairly be said that the government has been aware of the use of various practices, such as joint equal age assumptions. The preamble to the proposed regulations states that the regulations are "consistent with the existing practice of many (but not all) issuers of both contracts insuring a single life and contracts insuring multiple lives." Thus, the choice of a prospective effective date for the proposed new rules provides some indication that the government is not interested in challenging such practices, as long as they were actuarially reasonable.

Request for comments and the scheduled hearing. The Notice states that written or electronic comments must be provided by Aug. 24, 2005. Also, the Notice states that a public hearing is scheduled to take place on Sept. 14, 2005, and that requests to speak and outlines of topics to be discussed at that hearing must be received by Aug. 24, 2005. With respect to written comments, the Notice specifically requests comments on four topics:

1) The clarity of the proposed regulations and how they can be made easier to understand;

2) The industry's existing practice for determining the attained age to use under both last-to-die and first-to-die life insurance contracts;

3) The need for special rules for determining the attained age of one or more insureds to calculate mortality charges under the reasonable mortality charge rule of section 7702(c)(3)(B)(i); and

4) The effective date of the proposed regulations.

Insurers should think about their practices in regard to these (and other) points and consider providing input. The third point in particular may reflect the government's intention to address application of the reasonable mortality charge rule to joint life products in subsequent guidance.

Concluding thoughts. At the time of the enactment of §7702 in 1984, joint life products existed in the market, but there was no mention of such products in the statute or legislative history, and it has been unclear in certain respects how the statute would be applied to such contracts. With the amendment of §7702A in 1989, there finally came to be a statutory reference to the joint and last survivor product, but still little guidance existed.

The IRS and U.S. Treasury Department are to be commended for their efforts in promulgating guidance on these issues. In our view, much remains to be done in refining the proposed rules, particularly as they affect joint life products. We understand the government to be determined to finalize the proposed regulations, and equally determined to listen carefully to what commentators say about the proposal. Insurance industry input to the regulatory process is vital if workable rules are to be fashioned, together with needed transitional relief. ◀

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Role of the Tax Actuary

by Kory J. Olsen and Steven C. Chamberlin

The Taxation Section recently conducted a survey to gather information on the role of the tax actuary within insurance companies. The survey was sent to all Taxation Section members. Respondents were asked to provide one response per company group from the highest-ranking tax actuary (or the highest-ranking person involved with the questioned tax activities). We had a great response rate of 40 responses, giving us a very credible look at the tax actuary and a good view of the Taxation Section. Thank you to all our participants. Your responses will help to set the direction for the section.

The responses covered the spectrum of company sizes, with 1/4 from company groups with total assets under $1 billion, 1/4 from company groups with total assets of more than $100 billion, and 1/2 from company groups with total assets spread out evenly in between the two extremes.

The product areas of the responding companies are highly concentrated. Life insurance is the most common product with 90 percent of the respondents carrying it (56 percent of these companies listed life insurance as their primary product focus). Annuities were present in 75 percent of the responding companies with responses showing an 80 percent primary product concentration in life insurance and annuities (either individually or jointly). Health insurance was a distant third with 38 percent of the companies carrying health products.

Tax Actuary Position

The majority of respondents do not have a formal tax actuary position (77 percent). Of those company groups with a formal tax actuary position, either one or two actuaries fill that role. One respondent had as many as five actuaries that are considered tax actuaries. The tax actuaries are generally located in the tax area, with some located in the valuation, corporate or the controller's area.

The size of the responding company group seems to influence the existence of a formal tax actuary position. The survey found that of companies that have a tax actuary position: 70 percent employ more than 50 actuaries, 20 percent employ between 21 and 50 actuaries, and only one employs five actuaries or less.

With so few formal tax actuary positions, there is little formal training for that position. Training is almost entirely on-the-job training (75 percent). Of the remaining 25 percent, there is some additional form of training, but it is not part of a formalized program. With the formation of the Taxation Section, the plan is that more organized training opportunities will become available.

Although the duties of the tax actuary seem to vary widely from organization to organization there is some commonality in the work they perform. For example, most do a detailed periodic review of trends by product or exhibit (72 percent) and gather documentation and meet with the valuation area(s) (72 percent). In addition, the majority perform a cursory review of the valuation systems statutory reserve calculations with some doing a more detailed review and some doing no review. Just over half of the tax actuaries also have the responsibility of having a deep level of understanding of the statutory reserve authoritative guidance.

Reviewing seriatim detail reserve calculations is generally not a part of the tax actuary position. The survey showed that 57 percent do not do a detailed review for statutory reserves and 43 percent do not do a detailed review for tax reserves. If a review is done it is mostly at the cursory level, although doing a detailed reserve calculation for statutory and tax can provide the tax actuary with valuable insights.

Non Formalized Position

For company groups without a formal tax actuary position, their primary resource (i.e., the resource to do routine activities) for tax actuarial expertise is other in-house actuaries. The majority (50 percent) of these in-house actuaries is located in the valuation area(s) with an additional 12 percent located in the corporate area. Only 12 percent of the responding companies outsource to a consulting firm as their primary resource. However, as a secondary resource (i.e., advisors on certain technical issues on an as-needed basis), consulting firms are utilized by almost 50 percent of the responding company groups.

Education / Expertise

The respondents were asked how the tax actuaries (either formally or informally named) maintain or expand their level of expertise. The results were consistent over all the topic areas questioned. Most respondents achieve their educational needs from either actuarial seminars (SOA and other actuarial organizations) or from newsletters, periodicals and other tax-related publications. External seminars (accounting firms and non-actuarial organizations) contributed some, with their largest contribution being on the topic of GAAP guidance.

The educational needs appear to be primarily in the area of statutory reserving guidance, tax reserving guidance, risk based capital issues, GAAP guidance, hot topics within the industry and other industry issues.

Product-Specific Involvement

For those company groups with life (90 percent), annuity (75 percent) or health insurance business (38 percent), the survey requested additional information on the role of the tax actuary in the scope of their products. For the items listed in the table, respondents were asked to list whether their level of involvement was "responsible" (i.e., sign-off on it), "consulted" (i.e., provide input), "informed" (i.e., provided a copy after the fact) or "not involved." For most of the topics, the level of responsibility was higher for life and annuity business than it was for health insurance.

Some of the results are surprising. For example, only a small number of tax actuaries are responsible for reviewing tax to statutory reserve ratios and trends (36 percent life, 42 percent annuity and 22 percent health). With reserve liabilities being such a large portion of the insurance company balance sheet, differences between statutory and tax reserves can have a major impact on taxable income. Reviewing these ratios and trends can lead a tax actuary to focus in on a certain area or discover some unforeseen problem.

In addition, respondents were asked to indicate who else was involved in these processes besides the tax actuary. Multiple responses were allowed in this category. "Other actuaries" was the most common response, followed closely by "Accountants" for most of the topics. With "Other actuaries" being involved in so many of these activities, it indicates that the need to be knowledgeable about tax issues goes significantly beyond the tax actuary, as his role appears to be currently defined in many organizations. Or, alternatively, the tax actuary's role needs to be significantly expanded.

The responses for some of the topics were quite similar, and an average of the results is provided. Table 1 summarizes the results for these topics:

Table 1

1. *Determine tax reserve methodology and assumptions prior to product launch;*
2. *Review tax reserve to statutory reserve ratios and trends periodically;*
3. *Create tax reserve documentation for audit purposes; and,*
4. *IRS audit support on actuarial issues.*

	Life	**Annuity**	**Health**
Responsible	33%	41%	25%
Consulted	12	10	17
Informed	17	10	13
Not involved	38	40	56
Who else is involved in addition to the tax actuary?			
Other actuaries	52%	47%	48%
Accountants	28	30	31
Lawyers	9	7	11

Table 2

Monitor the progress of new or proposed actuarial regulatory guidance and its tax impacts.

	Life	**Annuity**	**Health**
Responsible	42%	48%	21%
Consulted	29	10	21
Informed	16	13	16
Not involved	13	29	42
Who else is involved in addition to the tax actuary?			
Other actuaries	49%	50%	43%
Accountants	24	29	30
Lawyers	18	11	17

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Table 3

Project results of planning initiatives dealing with pending new guidance and what approach to take.

	Life	Annuity	Health
Responsible	22%	16%	0%
Consulted	35	29	42
Informed	19	19	21
Not involved	24	35	37
Who else is involved in addition to the tax actuary?			
Other actuaries	41%	37%	41%
Accountants	33	34	41
Lawyers	16	13	11

Many tax actuaries are consulted in creating or assessing capital efficient ideas, although almost half have no involvement. The other individuals involved with capital efficient ideas are other actuaries and accountants (see Tables 2 and 3).

Most tax actuaries are not involved with writing opinion letters and very few have any responsibility with them. Other actuaries, accountants and lawyers (split evenly) generally write the opinion letters.

Non-Product Specific Involvement

The survey requested additional information on the tax actuary's level of involvement in a variety of non-product specific areas (see Table 4). The tax actuary was responsible for the work more than 30 percent of the time in only three of these areas (reserves for tax return preparation, guidance on section 7702/7702A, and general pension tax issues). The tax actuary was consulted more than 30 percent of the time in five more of the 16 areas. However, the tax actuary was not involved more than 40 percent of the time in 14 of the 16 areas. Tax actuaries might need to make others in their organizations aware that they are available to add expertise in these areas. This might imply that there is significant room for expansion of the tax actuary, in his role as an expert in tax actuarial matters.

Table 4

	Responsible	Consulted	Informed	Not informed
Tax return preparation: Reserves and reserve related items	32%	18%	9%	41%
Tax return preparation: Other than reserves and reserve related items	6	15	12	67
Tax return review	9	9	15	67
Dividends received deduction issues	6	15	18	61
Life/non-life consolidation issues	0	13	22	66
Review of business combinations and mergers	0	38	13	50
Review of reinsurance transactions	13	41	6	41
Calculate DTA/DTL for GAAP	3	6	26	65
Calculate DTA/DTL for Statutory	3	25	22	50
Determination of GAAP valuation allowances	7	7	13	73
Determination of tax payment cushions	6	16	13	65
Provide guidance on section 7702/7702A (life insurance)	47	26	9	18
Provide guidance on section 72, 1031, 1035 (annuities)	16	31	13	41
General IRS audit support	3	33	18	45
General property/casualty tax issues	0	7	10	83
General pension tax issues	53	41	3	3

Conclusion

The survey provides a wealth of information, which will take awhile to fully analyze. As we continue this analysis, we will share the results via the Taxation Section Web page or future articles in *Taxing Times*. From the analysis done so far, the survey shows that there is opportunity to expand the role of the tax actuary within companies and possibly to get more formal positions created throughout the industry. There are many insurance company taxation areas where a knowledgeable actuary can add value.

The survey also highlights areas where the Taxation Section can provide additional value to its members. Through the newsletter, Web page, and seminars, the section can provide educational opportunities for tax actuaries as well as provide information for expanding their role. Tax actuaries are few in number. Meetings and seminars can provide networking opportunities for actuaries to interact and learn from their peers. This survey showed just how much opportunity exists for this important knowledge exchange.

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"Federal Income Taxation of Life Insurance Companies" Seminar

The Taxation Section of the SOA and KPMG will be offering a 1 1/2 day seminar entitled "Federal Income Taxation of Life Insurance Companies" in Orlando, Fla. from Sept, 20-21, 2005 prior to the SOA Valuation Actuary Symposium. This seminar is intended to provide actuaries with an understanding of the general tax rules applicable to their companies. Seminar topics include:

- Basic Concepts in Life Insurance Company Taxation
- Definition of a Life Insurance Company
- Premium Income
- Investment Income and Capital Gains
- Policyholder Dividends and Differential Earnings Rate
- Proration of Tax Exempt Interest and the Dividends Received Deduction
- Small Life Insurance Company Deduction
- Policyholder Surplus Account
- Reserves
- Death Benefits and Discounting of Claim Reserves
- Policy Acquisition Expenses
- Reinsurance
- Separate Accounts
- Life/Non-life Consolidated Returns
- Statutory Accounting for Income Taxes
- Policyholder Taxation

It's not too late to register. For more information, visit the SOA Web site at *www.soa.org*.

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