TAXATION SECTION
"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"

VOL. 2 ISSUE 2
SEPTEMBER 2006

TAXING TIMES

Private Rulings Regarding "Cash Surrender Value" Under Section 7702

by Craig R. Springfield and Brian G. King

Last year the Internal Revenue Service (IRS) issued two private letter rulings, PLR 200521009 (May 27, 2005) and PLR 200528018 (July 15, 2005), that involved the meaning of the term "cash surrender value" as used in section 7702 of the Internal Revenue Code, which sets forth the federal tax definition of "life insurance contract." In these rulings, the life insurance contracts provided for payment of a "remittance" upon surrender of a contract that was in addition to the generally applicable policy value payable upon surrender. The IRS concluded that the remittances represented "cash surrender value" within the meaning of section 7702(f)(2)(A) and further concluded that the failure of the taxpayers to reflect the remittances as cash surrender value was a reasonable error under section 7702(f)(8).

Facts Involved in the Rulings

The contracts involved in one of the rulings were designed to comply either with the cash value accumulation test of section 7702(b) (CVAT) or the guideline premium limitation (GPL) and cash value corridor (CVC) tests of section 7702(c) and (d). In the other ruling, all of the contracts were designed to comply with the CVAT.

The contracts involved in the rulings provided a policy value that was available upon surrender – referred to in one of the rulings as the "Account Value" and in the other ruling as the "Accumulation Value." The remittance was not part of this policy value. Rather, the remittance was an additional amount payable upon the early surrender of a contract. (The rulings do not explain what was meant by "early" surrenders.) In one of the rulings, the remittance was defined as a percentage of premiums paid for the contract, and the specific percentage applicable depended upon when the surrender occurred and how much premium had been paid relative to the target premium for the contract. Part of the remittance was guaranteed from issuance, but the insurance company also paid certain non-guaranteed remittance amounts. In the other ruling, the remittance was defined as a percentage of certain charges assessed and depended upon when the surrender occurred.

In both of the rulings, no portion of the remittance could be borrowed against by the contract owner.

"Cash Surrender Value" Under Section 7702

Section 7702(f)(2)(A) defines cash surrender value for purposes of section 7702 as a contract's "cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." The code does not elaborate on the meaning of the term "cash value" as used to define cash surrender value in section 7702(f)(2)(A). Moreover, there are no final or temporary regulations providing guidance on the meaning of these terms, nor have any revenue rulings or other precedential guidance been published regarding their meaning under section 7702.

continued 4

contents

Private Rulings Regarding "Cash Surrender Value" Under Section 7702
Craig R. Springfield and Brian G. King — 1

From the Editor
Brian G. King — 2

From the Chair
Barbara R. Gold — 3

Highlights of the Recent Guidance on Insurance Company Acquisitions
Mark H. Kovey and Lori J. Jones — 9

The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves
Samuel A. Mitchell and Peter H. Winslow — 14

Removal of Profit/Loss Separation Rule from Life/Nonlife Regulations Eliminates Tax Issue from Securitizing Triple-X Business
Michael A. Bell — 18

The IRS Schedule M-3 for Insurance Companies
Amy C. Lewis — 22

When Are Guaranty Association Assessments Deductible?
Peter H. Winslow and Lori J. Jones — 24

T3: *Taxing Times* Tidbits — 26

Book Review
Greg Stephenson — 29

Actuaries
The Best-Kept Secret in Business™

TAXING TIMES
Vol. 2 Issue 2
September 2006

Taxation Section of the Society of Actuaries
475 N. Martingale Road, Suite 600
Schaumburg, IL 60173

- Phone: (847) 706-3500
- Fax: (847) 706-3599
- www.soa.org

This newsletter is free to section members. A subscription is $20.00 for nonmembers. Current-year issues are available from the Publication Orders Department by contacting Aleshia Zionce at (847) 706-3525. Photocopies of back issues may be requested for a nominal fee.

Expressions of opinion stated herein are, unless expressly stated to the contrary, not the opinion or position of the Society of Actuaries, its sections, its committees or the employers of the authors.

The SOA assumes no responsibility for statements made or opinions expressed in the articles, criticisms and discussions contained in this publication.

Chairperson: Barbara R. Gold, FSA
Vice-Chairperson: Leslie J. Chapman, FSA
Treasurer: George J. Hebel, Jr., FSA
Council Members: Douglas N. Hertz, FSA
Brian G. King, FSA
Peter A. Marion, FSA
Arthur V. Panighetti, FSA
James F. Reiskytl, FSA
Charles A. Wanner, ASA

Newsletter Staff
Editor: Brian G. King, FSA
Assistant Editor: Christine Del Vaglio
Editorial Board: Peter H. Winslow
Bruce Schobel, FSA
Fredrick Gelfond

DTP Coordinator: Joe Adduci

Copyright © 2006 Society of Actuaries.
All rights reserved.
Printed in the United States of America

SOCIETY OF ACTUARIES

FROM THE EDITOR

BRIAN G. KING

With the changing season, comes a change in the editorial board of *Taxing Times*. I have perhaps been a bit remiss in the past in introducing and acknowledging the work of our editorial board. Serving on an editorial board of a newsletter requires a commitment of time, energy and vision. Our deadlines and turnaround times are often very tight. In addition, the editorial board plays a key role in soliciting articles for upcoming issues and determining "hot tax topics" sure to hold our readers interest. Often they have been called upon to write articles themselves when volunteer articles have been sparse.

Since its inception, the editorial board of *Taxing Times* has been comprised of Peter Winslow, Bruce Schobel and Ernie Achtien. Peter Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLC; Ernie Achtien is a partner with Ernst & Young's Lake Michigan Insurance Tax Practice in Chicago; and Bruce Schobel is a VP and actuary with NY Life.

All three have done a fantastic job in meeting their editorial responsibilities and in bringing their unique discipline to the table. Some may ask what you get when you bring a lawyer, an accountant and an actuary together? My answer is a great editorial board for a Taxation Section newsletter. This cross-discipline approach to looking at insurance taxation is a critical component to our section and its multi-discipline membership. This initial editorial board with their unique backgrounds has bolstered the cross-discipline nature of our section.

I applaud all three of you for your efforts. I thank and acknowledge your past contributions and for Peter Winslow and Bruce Schobel, I am confident that your upcoming efforts will continue to help lead and shape the direction of *Taxing Times*. Ernie has stepped down from the editorial board and I along with our membership thank him for all his hard work and dedication.

In acknowledging the importance of the different disciplines, Ernie's replacement Rick Gelfond also comes from an accounting firm. He is senior manager with the Washington, D.C. National Tax office of Deloitte Tax LLP. In addition, Rick currently is co-editor-in-chief of Deloitte's Insurance Tax Update and as such, brings to the table a tremendous amount of knowledge and experience in developing a tax issues newsletters. He is also a past contributor to *Taxing Times* with his COLI Update article in last May's issue. On behalf of the entire Taxation Section, I would like to welcome Rick to our editorial board. I have enjoyed working with him on this issue and look forward to continuing on future issues.

Finally, in the midst of all the change, one constant remains. We as always continue to encourage our membership to contribute articles, generate questions and topics of interest and to get involved with your Taxation Section! Enjoy the issue.

Note From The Editor

All of the articles that appear in *Taxing Times* are peer reviewed by our editorial board and section council members. These members represent a cross-functional team of professionals from the accounting, legal and actuarial disciplines. This peer-review process is a critical ingredient in maintaining and enhancing the quality and credibility of our section newsletter.

While this newsletter strives to provide accurate and authoritative information in the content of its articles, it does not constitute tax, legal, on other advice from the publisher. It is recommended that professional services be retained for such advice. The publisher assumes no responsibility with assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

Citations are required and found in our published articles, and follow standard protocol.

Brian G. King, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. He may be reached at *brian_king@aon.com*.

FROM THE CHAIR

BARBARA R. GOLD

Calling all volunteers. You've seen the box asking for volunteers in past issues of *Taxing Times*, and, now in my chair column, I want to highlight some of the ways you can get involved in your Taxation Section. As one of the newest and smallest of the SOA sections, every contribution from our members is valuable and the opportunities to contribute are abundant. There are so many exciting activities happening in our section and so many ways for you to get involved.

As a volunteer, you have an opportunity to both share and expand your technical tax knowledge as well as influence the tax training and education of other actuaries. Volunteering will enhance your professional growth and development as well as benefit the Section, the actuarial profession and the broader tax community.

Taxing Times, our section newsletter, provides timely, thorough and informative articles and is rapidly becoming well regarded in the broader tax community. This is due to the quality work of our contributing writers and our peer review process, which brings together a cross-discipline team of tax experts to ensure the quality of our articles. In order to further enhance the quality and credibility of this publication, we are in the process of revising and expanding our peer review process so that each council member will be responsible for the review of specific articles. Volunteer activities abound in the *Taxing Times* arena. Peer reviewing one or more articles, writing an article concerning an area of specific interest to you, suggesting ideas for articles that would interest you, or a letter to the editor regarding a past article that has provoked thought all provide ways to get involved. Let us hear from you.

Perhaps you are one of those members for whom tax is not the primary focus of your work, but rather a portion of what you do. We have been establishing liaisons to other sections. Such a liaison role between the Taxation Section and another section is a great way to volunteer your services and benefits both sections. An important outcome of this relationship building is that the Taxation Section is being asked to provide speakers and topics for seminars. These seminars are not focused exclusively on tax, but tax is one issue being discussed. The upcoming Reinsurance and Capital Efficiency Seminars are results of collaboration between sections. These cross-sectional conferences as well as our seminars specifically devoted to tax issues, such as the Product Tax Seminar this month, all provide opportunity for members to speak.

The SOA is currently revamping its examination process. The Taxation Section is providing input on what should be included in the exams involving tax education for actuaries and is reviewing and possibly rewriting some of the Study Notes. Is this an area where you can help?

We need your input on the tasks listed above and also on identifying and studying emerging issues and emerging tasks. If something not mentioned above really interests you, consider the possibility of creating your own project to present to the Section Council. Just get involved and participate. Please contact Art Panighetti at *arthurpanighetti@northwesternmutual.com* to begin your volunteer work. ◂

Barbara R. Gold, FSA, MAAA, is vice president with Prudential Insurance Company in Newark, N.J. She may be reached at *barbara.gold@prudential.com*.

The lack of authoritative guidance is perhaps indicative of the fundamental nature of the term, given the various contexts in which the notion of a life insurance contract's cash value is important (for tax purposes and otherwise) and given product designs that vary in the mechanisms they employ with respect to making cash payments available prior to an insured's death. Nonetheless, properly identifying a contract's cash value and cash surrender value within the meaning of section 7702(f)(2)(A) is of critical importance for purposes of complying with the CVAT, since this test requires that, by a contract's terms, the cash surrender value must not at any time exceed the net single premium applicable under the contract at that time. This term is similarly important to satisfaction of the CVC, which requires the death benefit under a contract to be at least a certain percentage, varying by age, of the contract's cash surrender value.

The IRS's Analysis

The IRS's analysis as set forth in the above private rulings began with a discussion of the common meaning of cash surrender value and cash value as described in certain insurance texts. One such text defined the term cash surrender value as "the amount made available contractually, to a withdrawing policyowner who is terminating his or her protection." Kenneth Black, Jr. & Harold D. Skipper, Jr., *Life & Health Insurance* 46 (13th ed. 2000) ("Black & Skipper"). Another cited text defined cash value as the "amount available to the policyholder upon the surrender of the life insurance contract." John H. Magee, *Life Insurance* 599 (3rd ed. 1958).

It is noteworthy that Black & Skipper provides additional commentary regarding the meaning of cash surrender value that, while not cited by the IRS, may be relevant in defining this term under section 7702. Specifically, Black & Skipper, at p. 993, describe cash surrender value as "[t]he amount of prefunded mortality charges that is available to a terminating policyowner." In other words, the cash surrender value of a contract at any time is the dollar amount under the contract accumulated to pay for insurance coverage to be provided in future years. In the context of universal life insurance policies, this value often is the contract's policy value (or other similar term, such as account value or accumulation value as in the private rulings). This interpretation is supported by the additional observations in Black & Skipper, at p. 235, that –

> Cash-value policies may be surrendered for their net surrender value …. The available net surrender value is the gross cash value shown in the policy, decreased by any surrender charges … and the amount of any policy loans outstanding, and increased by the cash value of any paid-up additions, any dividends accumulated at interest, and any prepaid premiums.

Applying this language to a universal life insurance contract, the cash value for which a contract may be surrendered is its policy value reduced by surrender charges and policy indebtedness. Section 7702(f)(2), however, disregards surrender charges and policy indebtedness (i.e., they are not netted against a contract's cash value), and thus the contract's policy value, or "gross cash value" to use Black & Skipper's term, is the amount that constitutes its cash surrender value for purposes of section 7702.

The IRS next cited the legislative history of section 7702, which provides that "cash surrender value" is defined in the bill as "the cash value of any contract (*i.e.*, any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend." S. Print No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984). The IRS did not elaborate upon this legislative history description, but it is noteworthy that this passage, while largely following the statutory language, provides insight regarding Congress' understanding of the term "cash value" as used in the definition of cash surrender value—*i.e.*, that cash value is the amount available "upon surrender *and* against which the policyholder can borrow." (Emphasis added.)

The IRS finally discussed the 1992 proposed income tax regulations (never finalized) defining cash value which provide that this term generally equals the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract. *See* 57 Fed. Reg. 59319 (Dec. 15, 1992). While not noted by the IRS, these proposed regulations further provide that the term cash value does not include (1) the amount of any death benefit (as defined in the proposed regulations), (2) the amount of any qualified additional benefit, (3) the amount of certain benefits payable upon the occurrence of a morbidity risk, (4) an amount returned to the

insured upon termination of a credit life insurance contract due to a full repayment of the debt covered by the contract, or (5) a reasonable termination dividend not in excess of $35 for each $1,000 of the face amount of the contract. See Prop. Treas. Reg. section 1.7702-2(b)(2).

The more important question remains, however, regarding how companies construe the meaning of cash surrender value under current law.

As recognized by the IRS later in the private rulings, the proposed regulations are materially different from the legislative history noted above with respect to the treatment of amounts subject to borrowing. Specifically, use of the operative word "and" in the above legislative history appears to contemplate that an amount must be subject to borrowing in order to be considered a cash value. In contrast, use of the operative word "or" in the proposed regulations appears to contemplate the opposite—*i.e.*, that an amount does not need to be subject to borrowing in order to constitute part of a contract's cash surrender value. The interpretation based on the legislative history—that an amount must be subject to borrowing in order to be a cash value – is bolstered by a later passage in this history which provides that the amount payable upon certain terminations of credit life insurance contracts "will not be considered part of any cash surrender value *because*, generally, such amount is not subject to borrowing under the policy." (Emphasis added.) S. Print. No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).

The IRS did not cite the Joint Committee on Taxation's Bluebook explanation on this point, which is phrased slightly different from the official legislative history. Specifically, it identifies cash value as "any amount to which the policyholder is entitled upon surrender and, generally, against which the policyholder can borrow." Staff of the J. Comm. on Tax'n, 98th Cong., General Explanation of the Deficit Reduction Act of 1984, at 647 (Comm. Print 1984).

Based on the above analysis, the IRS concluded that the remittances constituted part of the cash surrender value of the contracts, thus causing contracts designed to comply with the CVAT to fail this test. In addressing whether the company's error of not treating the remittances as cash value was a waivable error under section 7702(f)(8), the IRS noted that, under Notice 93-37, 1993-2 C.B. 331, the effective date of the proposed regulations would be no earlier than the date of publication of final regulations in the Federal Register (which has not yet occurred). The IRS then observed that the proposed regulations do not contain language that is identical to the definition of cash surrender value in the legislative history of section 7702. For these reasons, the IRS concluded that the error was waivable in both of the private rulings.

Implications of the Rulings

The current state of the law regarding the meaning of cash surrender value under section 7702 is unclear at the present time, given the paucity of guidance contained in the statute and legislative history and the 13 years during which we have been living with proposed regulations that have not been finalized or issued in temporary form. This uncertainty in the law, together with Notice 93-37, appears to have been significant to the IRS's granting of relief under the waiver provision of section 7702(f)(8).

The more important question remains, however, regarding how companies should construe the meaning of cash surrender value under current law. Significantly, the holdings of the private rulings appear *to not* follow the official legislative history of section 7702 (as the IRS seems to have recognized), and instead appear more in line with the proposed regulations that are not yet effective. Also, the stakes involved are very material. In the case of contracts designed to comply with the CVAT especially, given that the terms of the contract must ensure compliance with the test at all times, even minor errors in accurately identifying cash value can result in non-compliance with this test.

Characteristics of the remittances that were important While private rulings are not precedential, the IRS's current views regarding the meaning of cash surrender value under section 7702 can in some respects be identified from the characteristics of the remittances addressed by the rulings. First, the IRS looked to the meaning of cash value under state law

continued ▸▸ 6

from pg. 5

and appears to have interpreted such law as more broadly defining cash value than the policy values of the contracts in the private rulings. This point is important to bear in mind since contract design and administrative systems usually focus on policy values, and rarely do insurers look beyond the policy value to ascertain a contract's cash surrender value for purposes of section 7702. Examining the meaning of cash value as traditionally interpreted under state insurance law is entirely appropriate, given that the meaning of this term under such law at the time of section 7702's enactment arguably is highly relevant to understanding the proper meaning of the term. Some might argue, however, that in the context of the facts of the rulings, this value was exclusively represented by the contracts' policy values. (*See*, for example, the discussion above regarding passages from Black & Skipper not discussed in the rulings.) The IRS, however, appears to have given substantial weight to the fact that the remittances would increase the amount payable upon a surrender, and the nature of such payments and their function within the contract seemingly were given lesser weight. In this regard, while the remittances were not, in fact, termination dividends (which generally are excluded from cash surrender value under the statute), in some respects such amounts are analogous to such dividends.

A second feature of the remittances that provides insight into the IRS's views regards the fact that such amounts were only payable for limited durations, *i.e.*, in connection with "early" surrenders. In other words, it appears that the remittances were available for a temporary period, and then they vanished and had no continuing effect on the contracts. In this respect, the remittances arguably could have been characterized as pertaining to a rescission of a contract but not as amounts that constitute cash value. While the timeframes are not identified in the rulings, the presence of amounts of a rescissory nature under life insurance contracts, and the need to exclude such amounts from cash value, is not unique to the contracts addressed by the rulings. Perhaps the strongest case could be made for return of premium benefits payable during the free-look period of a contract. These benefits return the premiums that have been paid, including any charges that have been assessed. Such returns of charges arguably are very similar to the remittances. At the same time, most would say that it is "stating the obvious" to conclude that free look amounts are not part of a contract's cash value for section 7702 purposes. Where the IRS would draw the line between such amounts and the remittances is unclear, and not addressed by any guidance.

The temporary period during which the remittances were available appears to be a very relevant consideration to whether such amounts constitute cash surrender value in light of the legislative intent underlying the enactment of section 7702 of constraining the investment orientation of life insurance contracts. *See* S. Print No. 98-169, at 572 (1984); H.R. Rep. No. 98-432, at 1443 (1984). On the one hand, the presence of an additional amount available on surrender lessens the net amount at risk to the insurer, *i.e.*, the pure insurance element, involved with the death benefit, and correspondingly an insurer generally would need to charge less for coverage than would be the case absent the additional amount payable on a surrender. Thus, the presence of any additional amount payable on a surrender arguably increases investment orientation, since the return on investment possible in connection with a surrender is higher due to the lower net amount at risk. On the other hand, if the remittances only applied for a relatively limited duration and did not later affect the policy values of the contracts (as appears to be the case), it seems questionable to view the remittances as increasing the contracts' investment orientation.

A third feature of the remittances adds to the lack of investment orientation associated with these amounts: the apparent lack of any interest or gains, *i.e.*, inside build-up, that were ever credited to the remittances. Since section 7702 is concerned about excessive investment orientation, one can reasonably ask whether this concern is materially present in the first instance with respect to amounts on which no inside build-up accrues. While, as noted above, the IRS could argue that all amounts payable on surrender reduce net amount at risk, and thus the net amount at risk to the company for which cost of

insurance charges need to be assessed, this concern would seem limited with respect to amounts payable on which no inside-build-up accrues. As a practical consideration, the potential that net amount at risk would ever be materially diminished under a life insurance contract by amounts on which no investment return is available seems unlikely since, to the extent such amounts truly are in the nature of cash value, policyholders will demand an appropriate return with respect to such investment.

Ramifications for calculations under section 7702 and 7702A In the private rulings, the principal focus was on whether the remittances constituted part of the cash surrender value of the contracts. A conclusion that an amount constitutes cash-surrender value may have an additional consequence under sections 7702 and 7702A that should be considered as well. Specifically, if an amount constitutes cash value and is provided on a guaranteed basis, does this affect the guarantees under a contract that are taken into account in calculating guideline premiums, net single premiums, and seven-pay premiums under these statutes? The presence of an additional guaranteed cash value arguably could be viewed as resulting in an increased interest rate guarantee in certain circumstances. In addition, if the additional cash value returns to the policyowner certain expenses that have been charged, this may imply that such expenses are so contingent that they should not be taken into account in calculating guideline premiums in the first instance.

Conforming Changes Permitted

Notice 93-37, which as noted above announced that the effective date of the proposed regulations under section 7702 would be no earlier than the date of publication of final regulations in the Federal Register, also outlined a relief provision that was anticipated for the final regulations. Specifically, the notice states that "is anticipated that insurance companies generally will be allowed a period of time after final regulations are published to bring their policy forms into compliance with any new rules." It is unclear whether this reference to "policy forms" was intended to include in-force policies or the forms that insurers use to issue policies. It should be construed to encompass both.

It is interesting to note, however, that the cited passage refers to "putative cash surrender value," and this reference arguably is viewing a contract's putative amount, i.e., its policy value, as being the same as its cash surrender value.

Legislative History Relating to Cash Surrender Value under Section 7702A

In connection with explaining certain amendments to section 7702A made in 2002, the Joint Committee on Taxation commented that the definition of cash surrender value under the so-called "rollover rule" of section 7702A(c)(3)(ii) was, by cross-reference, the same as that in section 7702. The Joint Committee then stated that, for purposes of applying this rule, "it is intended that the fair market value of the contract be used as the cash surrender value under this provision, if the amount of the putative cash surrender value of the contract is artificially depressed." Staff of the J. Comm. on Tax'n, 107th Cong., Technical Explanation of the "Job Creation and Worker Assistance Act of 2002" (Comm. Print 2002). This legislative history seems to have little relevance for purposes of generally defining cash surrender value, since it appears to function solely as an anti-abuse rule directed at limited situations. It is interesting to note, however, that the cited passage refers to "putative cash surrender value," and this reference arguably is viewing a contract's putative amount, *i.e.*, its policy value, as being the same as its cash surrender value.

Concluding Thoughts

The IRS's holdings in the private rulings are consistent with the 1992 proposed regulations, even though such regulations are not currently effective. In this regard, the framework of these regulations is that all amounts payable upon a surrender are includible in cash surrender value unless they are covered by one of the listed exclusions. When the IRS issued the proposed regulations, comment letters from taxpayers emphasized that the proposed definition of cash surrender value was overly broad, and that if the structure of the regulations was retained it would be necessary for numerous

continued ▸▸ 8

⏭ Private Rulings Regarding "Cash Surrender Value" …
from pg. 7

additional exclusions to be incorporated into the regulations. Of particular relevance to the private rulings, the American Council of Life Insurers in its comments proposed, *inter alia*, that any "pro-rata portion of a periodic premium payable on contract termination or *any pro-rata refund of charges assessed in advance under the contract*" be specifically excluded from cash surrender value (emphasis added). The private rulings show, non-precedentially, that the IRS disagrees with respect to the appropriateness of this requested exclusion, at least under the facts set forth in the rulings.

In the absence of final regulations or other published guidance, we are left with considerable uncertainty regarding the meaning of cash surrender value in circumstances where benefits or contract provisions entail cash payments upon a surrender beyond the putative cash value represented by a contract's policy value (or other similar term that might be used). In situations where a contract includes such payments, careful analysis should be undertaken to determine whether it should be included in cash surrender value, rather than simply assuming that the policy value equates to the cash-surrender value.

One open question regards how the relief provided by Notice 93-37—allowing insurers to conform to final regulations—will be accomplished. If final regulations were issued, a procedure could be established to address this question. In the absence of final regulations, it seems that making a request for a private ruling (*e.g.*, an affirmative ruling that an amount is not a cash surrender value and possibly a request for waivers should the IRS disagree) is the only avenue currently available to obtain certainty with respect to the tax treatment of such amounts. For many, the best practical choice will be to simply adopt a conservative position, *i.e.*, view amounts in question as cash surrender value even though good arguments might be made to the contrary. However, this likely would not be a viable alternative for many. In light of the importance of this definitional question, a better solution may be for the IRS to consider the issuance of formal guidance reflective of the dictates of the statute, legislative intent, and due consideration of industry comments. ◀

Brian G. King, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. He may be reached at *brian_king@aon.com.*

Craig R. Springfield is a partner with the Washington D.C. law firm of Davis & Harman LLP. He may be reached at *cspringfield@davis-harman.com.*

Highlights of the Recent Guidance on Insurance Company Acquisitions

by Mark H. Kovey and Lori J. Jones

Final tax regulations issued in April provide helpful guidance on the acquisition of insurance companies pursuant to an election under section 338 of the Internal Revenue Code and the reinsurance of blocks of insurance when accompanied by the acquisition of other intangible assets, such as a customer list or a distribution network. The new regulations apply to all types of insurance companies, life, property casualty, health, title and so forth, and potentially to all forms of reinsurance (including indemnity, assumption and retrocessions). The following describes many significant issues and discusses the fact that "mere" reinsurance remains subject to the old regulations under Treas. Reg. section 1.817-4(d), which may result in a different answer for federal tax purposes.

After waiting for over 20 years since the enactment of section 338, the regulations finally instruct insurance companies how to treat an election under section 338 as a deemed assumption reinsurance transaction. When the stock of a target insurance company (the target) is purchased, an election under section 338(g) or section 338(h)(10) will result in the transaction treated for federal income tax purposes as if there is no sale of the stock of the target. Instead, the transaction is treated as a taxable sale by the "old" target of all its assets to the "new" target, followed by a deemed liquidation of the old target into its selling shareholder, and the new target is treated as a new taxpayer after the deemed asset sale. The deemed asset sale requires the old target to recognize gain or loss on the deemed transfer of its assets and the new target to receive a new tax basis in those assets (usually at the current fair market value). In addition, the regulations treat the deemed asset sale as a taxable assumption reinsurance transaction between the old target and the new target, which impacts on various tax issues including reserves, tax DAC under section 848 and other aspects of determining underwriting income. Some of the issues are covered by temporary regulations (also released as proposed regulations) so taxpayer comments can be received before final adoption of the rules. However, the final and temporary regulations are effective now.

The adopted regulations also apply to a novel category of reinsurance, one defined in the regulations as reinsurance combined with the transfer of significant business assets that is an "applicable asset transaction" defined in section 1060. Mere reinsurance of insurance contracts is not an applicable asset acquisition even if it enables the reinsurer to establish a customer relationship with the policyholders. Treas. Reg. section 1.1060-1(b)(9). The transfer of an insurance business is an applicable asset acquisition if the purchaser acquires significant business assets, in addition to the reinsurance of insurance contracts, to which goodwill and going concern could attach. Little further guidance is provided. It appears to us that reinsurance of a block of business when there is also a transfer of the right to solicit customers, the distribution or marketing operation or the core operating software for underwriting and administering the book of business will constitute significant business assets to bring the transaction under the new section 1060 rules. Assumption reinsurance, indemnity reinsurance and retrocessions can be applicable asset acquisitions subject to section 1060 but only if there is also the transfer of significant business assets. See Treas. Reg. section 1.1060-1(b)(5).

Assumption Reinsurance Rules Apply With Cap to Assuming Company

The deemed sale of assets pursuant to a section 338 election is treated as assumption reinsurance for tax purposes, but special rules are provided under section 338 that differ in some respects from the existing assumption reinsurance regulations at Treas. Reg. section 1.817-4(d). See Treas. Reg. section 1.338-1(a)(2). Those same provisions are also applicable to a section 1060 reinsurance transaction. Thus, the new regulations apply to deemed reinsurance (section

continued 10

from pg. 9

338 election) and actual reinsurance (section 1060 reinsurance transaction).

The closing tax reserves of the old target (ceding company) are treated as fixed, not contingent, liabilities in determining the old target's gain or loss on the deemed or actual sale of its assets (based on the total amount of consideration received) and the total amount of tax basis of the assets deemed or actually acquired by the new target (assuming company). Treas. Reg. section 1.338-11(b). Following the usual method applied for other section 338 and 1060 transactions, the residual method is used to allocate the total amount of consideration and total amount of tax basis among all classes of transferred assets, including the "insurance contracts" (which is the new regulations' term for the ceding commission or the insurance in force value). The residual method allocation will be applied before applying the reinsurance tax rules so that the residual method determines what amount is allocated to the ceding commission before applying the reinsurance tax principles to the actual or deemed reinsurance transaction.

The final regulations responded favorably to insurance industry requests to prevent immediate premium income to the assuming company of "phantom" income when there is a negative ceding commission in the actual or deemed reinsurance transaction. In theory, there can be a negative ceding commission whenever the agreement requires the ceding company to transfer assets with a greater fair market value than the reserves transferred. This can occur for many reasons, such as under-reserving by the ceding company or the nature of the bargain struck by the parties. However, because tax rules utilize the tax measure of reserves (and not statutory, GAAP or other measures), the usually lower amount of tax reserves can create a negative ceding commission for tax purposes when one did not exist under another measure of the reserves. When the tax reserves are less than the statutory reserves, the required transfer of the same amount of assets will result in either a negative ceding commission for tax purposes or a reduced positive ceding commission.

The new regulations prevent immediate premium income to the new target (assuming company) by declaring that the gross amount of the reinsurance premium paid by the old target (ceding company) to the new target will be deemed equal to the old target's closing tax reserves in all cases. Treas. Reg. section 1.338-11(c)(2). Although not stated as a "cap," the rule works as a cap because neither party can be treated as transferring or receiving a reinsurance premium that exceeds the tax reserves actually or deemed transferred. If the cap applies and the amount allocable to the insurance contracts is negative, the new target will likely have reduced asset basis as a cost for not having immediate net premium income while the old target will have a reduced underwriting deduction on the transfer but also will have reduced gain or increased loss on the deemed or actual sale of its assets. Consequently, for the ceding company this may be a change of character from ordinary deduction to capital loss while for the assuming company there is a timing item and probably also a change in character.

Valuation of Insurance in Force

Under the regulations, the amount allocable to the insurance contracts is taken into account in determining the ceding company's income or gain (or loss) and the assuming company's asset basis. For this purpose, the regulations provide that the fair market value of the insurance contracts is the amount a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of specific insurance contracts if the gross reinsurance premium for the insurance contracts were equal to the ceding company's tax reserves for the insurance contracts. Treas. Reg. section 1.338-11(b)(2). In order to maintain consistency with other provisions of the code whereby the amount of the insurance liability for tax purposes is the tax reserve, the regulation adopts a value of insurance in force, which artificially looks to tax reserves rather than statutory reserves. As indicated earlier in the article, this could result in a negative ceding commission in the situation where statutory reserves exceed tax reserves, and the assets transferred (or deemed transferred) for the insurance liabilities equal the statutory reserves. Despite numerous comments being filed by the industry in response to this definition in the proposed regulations, the IRS kept the same definition in the final regulations and did not provide an illustration as to how this amount would be determined.

One way to interpret the rule is that the value of the insurance contracts should be determined on the basis of standard actuarial principles (using statutory reserves) and then the resulting amount should be reduced by an amount equal to the excess of the statutory over the tax reserves. This would likely result in a lower value of insurance in force for tax purposes, as compared to a normal actuarial valuation. On the other hand, one could interpret the rule as requiring the substitution of

tax reserves for statutory reserves in determining distributable earnings, which would have the result of increasing the value of insurance in force (because essentially the liabilities for tax purposes would be lower). The problem with this approach is that it probably was not what was intended. Thus, until and unless further guidance is issued, the two-step approach set forth above appears to be the more reasonable interpretation of the regulation.

Reinsurance as DAC Transaction

The deemed asset sale under section 338 is also treated as reinsurance for purposes of applying the tax DAC provisions under section 848. Section 848 requires the capitalization and amortization generally over ten years of specified policy acquisition expenses on life insurance and annuity contracts. The existing rules in Treas. Reg. section 1.848-2 for actual reinsurance transactions are also applied to the deemed reinsurance under section 338 although additional guidance in the final and temporary regulations provide helpful detail. These rules also apply to a section 1060 actual reinsurance transaction. Thus, the negative capitalization amount that generally results from the ceding company's reinsurance of liabilities under life, annuity and noncancellable accident and health contracts will first reduce its current year's capitalization requirement and then will offset any unamortized DAC that the ceding company capitalized in prior years, which will produce a current expense deduction. Under the DAC tax consistency approach, the assuming company will usually have a positive DAC in the same amount that must be capitalized and amortized generally over ten years. The positive and negative capitalization amounts are determined by treating as the "net consideration" in the deemed or actual reinsurance transaction the difference between the ceding company's tax reserves on the block of business transferred and the ceding commission. The final regulations specify that the parties to the actual or deemed reinsurance transaction can make the election under Treas. Reg. section 1.848-2(g)(8) to determine the amount of expenses capitalized under section 848 without regard to the reinsurer's general deduction limitation. Useful examples illustrate how to calculate the tax DAC consequences of an actual or deemed reinsurance transaction, including the method of determining what portion of the ceding commission is amortizable under the ten-year regime of section 848 and what portion is subject to 15-year amortization under section 197(f)(5). See Temp. Treas. Reg. section 1.197-2T(g)(5)(ii)(D).

The regulations also limit the carryover of any remaining tax DAC attributes. Thus, if the parent company of the old target that is subject to an election under section 338(h)(10) is an insurance company, the DAC attributes will carryover to the parent under section 381(c)(22) on the deemed liquidation of the old target. However, if the parent is not an insurance company, any remaining unamortized DAC in the old target will be immediately deductible to the old target and any remaining excess negative capitalization amount in the old target will be eliminated.

Section 815 PSA Triggered Generally

The regulations unkindly trigger tax on "phase III" income in most section 338 transactions, although most companies will have eliminated their policyholders surplus account (PSA) by the end of 2006 and thus will have no concern about adverse results under this provision. It provides as a general rule that when a target stock life insurance company is sold pursuant to a section 338(g) election, an amount generally equal to the purchase price of the target's stock will be treated as a distribution under section 815. Treas. Reg. section 1.338-11(g). If the purchase price exceeds the shareholders surplus account (SSA), an amount will be taken into income as a distribution out of the PSA. If the purchase price does not exceed the combination of the SSA and the PSA, any remaining PSA is not triggered and should go untaxed because the new target will not inherit the remaining PSA. An exception to the general rule is that, if 50 percent of more of the old target's insurance business is in fact transferred to Target's parent life company, the PSA and other section 815 accounts will carryover to the parent in a section 338(h)(10) election. When less than 50 percent is transferred, the parent will succeed to a pro rata portion of the section 815 accounts, based on a ratio of the transferred reserves to total reserves. The remaining amount of PSA not carried over to the parent is taken into income.

Three Provisions of Most Interest to P&C Companies

Certain Post Transaction Reserve Deductions Must Be Capitalized—The regulations require capitalization of increases to unpaid loss reserves (including loss claims

continued 12

from pg. 11

and loss adjustment expenses) to the extent that, under the regulations, the deemed or actual reinsurance transaction includes a negative ceding commission. Temp. Treas. Reg. section 1.338-11T(g). Capitalization is not required for post-acquisition increases in reserves while the insurer is under a state receivership proceeding or to the extent the deduction for the reserve increase for a life insurance company is spread over ten years under section 807(f). Temp. Treas. Reg. section 1.338-11T(d)(2).

Capitalization is required if the reserve is increased at any time after the reinsurance transaction if the assuming company still has the liability. In a noteworthy change made in response to industry comments, the requirement to capitalize reserve increases only applies in situations when the deemed or actual reinsurance transaction involved a negative ceding commission, and, only to the extent of the negative ceding commission. See Temp. Treas. Reg. section 1.338-11T(d)(6). When capitalization is required, the assuming company will be required to include an amount in gross income to offset the increase in reserve deduction and include the same amount in the basis of assets. The ceding company will not make any adjustments.

Section 847 Estimated Tax Payments on Unpaid Losses Will Disappear—The deemed asset sale by the old target under section 338 will cause its special loss discount account under section 847 to be reduced and the reduction taken into income, except to the extent that the old target actually distributes the lines of insurance business subject to section 847 to an insurer parent. Treas. Reg. sections 1.338-11(h) and 1.381(c)(22) - 1(b)(14). The old target may use its special estimated tax payments under section 847 to offset this inclusion of income, but any special estimated tax payments remaining will be voided and disappear.

Section 846(e) Election Can Continue in a Section 338 Election—The new target is permitted to apply the old target's experience as a result of any section 846(e) election to compute discounted unpaid losses using the company's historical payment patterns. Therefore, after a section 338 election when the old target has a section 846(e) election in effect, the new target can choose to continue to use the historical loss payment pattern of the old target or may revoke the election. Temp. Treas. Reg. section 1.338-11T(e).

Retroactive Elections

The regulations permit an election to apply the final section 338 regulations to qualified stock purchases which occurred before April 10, 2006, if all taxable years for which the consequences of the section 338 election affect the computation are open. If a section 338(h)(10) election was made for a domestic target or a section 338(g) election was made for a foreign target, either the seller or the purchaser can independently choose to apply the regulations retroactively. Treas. Reg. section 1.338(i)-1(c)(2) and (3). In the unusual case when a section 338(g) election was made for a domestic target, both the old and the new target must agree in order to apply the regulations to transactions that occurred prior to April 10. For application of the new section 1060 rules, the election to apply the regulations retroactively can be made independently by either the purchaser or the seller. Treas. Reg. section 1.1060-1(a)(2)(i).

Conclusion

The regulations provide long-awaited guidance on issues that sellers and buyers of insurance companies and blocks of insurance need certainty. Having definite rules will assist the parties negotiating the purchase price or ceding commission by tending to prevent claims by one side or the other of uncertain tax results. Although very instructive and even helpful in providing guidance on many open issues, the new regulations are deficient in not defining more clearly when actual reinsurance is subject to the new rules instead of the old regulations. Perhaps this gap in guidance will be filled by taxpayers seeking private letter rulings or by other forms of guidance.

Mark H. Kovey is a partner with the Washington, DC law firm of Scribner, Hall & Thompson, LLP. He may be reached at *mkovey@scribnerhall.com.*

Lori J. Jones is a partner with the Washington, DC law firm of Scribner, Hall & Thompson, LLP. She may be reached at *ljones@scribnerhall.com.*

Section Member Registration Contest

FutureRisk.*org* and the Taxation Section want you!!!

Help out the Taxation Section by registering for **FutureRisk.*org***. The SOA Section with the highest percentage of members registering with FutureRisk.org by October 31 will be awarded a cash prize. In addition, 25 section members will be randomly selected for cash prizes too!

Registration is open to both SOA and non-SOA members.

What is FutureRisk.*org*?

- FutureRisk.*org* is a research Web site
- Sponsored by SOA, powered by Association DataZone
- Database captures demographics about registrants
- Measures trends over time
- Easy, low-cost access to opinions & information

Once registered, you will be invited to participate in surveys, which will be used to:

- Give insight into issues facing the actuarial profession
- Shape SOA policies and decisions
- Help evaluate and improve SOA products and services

Register today and learn more by visiting **www.FutureRisk.*org*.**

Preferred Mortality Study Preliminary Results to be Revealed at Annual Meeting

The SOA is currently sponsoring the largest, most complex and multi-faceted mortality study ever undertaken by an actuarial organization. Our initial research, to be unveiled Oct. 15-18 at the SOA Annual Meeting, will reveal the results of experience studies that will support redefinition of reserve requirements for preferred life policies. The likely outcome of this project will be to better reflect preferred mortality in life insurance liabilities while still assuring adequate protection for policyholders and investors. Learn more about this study by going to **www.soa.org** and searching for "preferred mortality."

The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves

by Samuel A. Mitchell and Peter H. Winslow

With the hiring of Interal Revenue Service (IRS) tax actuaries in recent years, IRS examiners are paying closer attention to life insurance reserves in general. In addition to technical issues pertaining to how the reserves are computed, the agents are raising basic legal questions sometimes casting doubt on settled law. One area of particular attention has been deficiency reserves. In a troubling development, examiners are dredging up an old Field Service Advisory (FSA) from 1993, in which a National Office attorney incorrectly concluded that the statutory reserve cap in Internal Revenue Code section 807(d)(1) excludes deficiency reserves.[1] A deficiency reserve is a reserve in addition to the basic life insurance reserve that is equal to the present value of the excess of future net premiums over future gross premiums to be received on a life insurance contract. Historically, deficiency reserves were not deductible because they were held to be an additional reserve that is not held for future claims (*i.e.*, a type of surplus reserve).[2] The prohibition on the deduction of deficiency reserves carried over into the current life insurance reserve taxation rules in section 807(d), enacted as part of the Tax Reform Act of 1984.[3] Section 807(d) provides that the deductible reserve for a life insurance contract is the greater of net surrender value or the Federally Prescribed Reserve (FPR) calculated under prescribed interest rate and mortality assumptions, but in no event can the tax reserve exceed "aggregate statutory reserves" (*i.e.*, the statutory cap). The aggregate statutory reserves cap in section 807(d) originally was defined by cross-reference to the differential earnings amount calculations for mutual companies in former section 809.[4] Section 807(d)(3)(C), in turn, provides that the FPR cannot include deficiency reserves. The issue addressed in the FSA is whether the exclusion of deficiency reserves applies only to the FPR calculated under the assumptions in section 807(d), or also to the aggregate statutory reserve cap.

The most logical place to start the analysis of whether the aggregate statutory reserves cap in section 807(d) includes deficiency reserves is with an explanation of the dual role statutory reserves originally played in the 1984 Act. Under the 1984 Act, aggregate statutory reserves were used not only to cap the tax reserve deduction, but also to measure the increase to a mutual company's equity base in order to calculate the differential earnings amount for the reduction of the policyholder dividend deduction. The computation of the equity base began with a mutual company's surplus and capital as reflected on its NAIC annual statement, which was then adjusted for several items. One adjustment was to increase the equity base by the excess of the "aggregate amount [of

---

[1] See 1993 WL 1609132 (Feb. 26, 1993). An FSA was an advice document provided by National Office attorneys to Field agents without the participation of the taxpayer. The documents are among a number of types of Chief Counsel Advice subject to public disclosure in redacted form under section 6110. At the time the FSA was drafted in 1993, the IRS took the formal position that FSAs were simply the opinion of one Chief Counsel Attorney, and, as such, covered by the governmental deliberative process privilege and thus not be subject to public disclosure. The IRS lost this battle in court, Tax Analysts v. Internal Revenue Service, 117 F.3d 607 (D.C. Cir. 1997), and Congress subsequently amended section 6110 to require disclosure of FSAs and other advisory documents known as Chief Counsel Advice. IRS Restructuring and Reform Act of 1998, sec. 3509, Pub. L. No. 105-206 (1998). Ironically, since the IRS lost the Tax Analysts FSA case and Congress amended section 6110, agents seem inclined to rely on FSAs to support adjustments, particularly in areas such as life insurance reserves where there is not an abundance of published guidance—this, in spite of the section 6110(k), which provides that Chief Counsel Advice, including FSAs, private letter rulings and the like cannot be cited or relied on as precedent.

[2] North American Reassurance Co. v. Commissioner, 29 BTA 683 (1934).

[3] Pub. L. No. 98-369 sec. 211(a) (1984).

[4] Repealed by Pub. L. No. 108-218(2004).

reserves] set forth in the annual statement" over the amount of tax reserves.[5] Because this adjustment resulted in a larger reduction of the policyholder dividend deduction, the Joint Committee on Taxation's Staff Report (1984 Bluebook) makes it clear that Congress wanted to make sure that statutory reserves for this purpose included deficiency reserves.[6] The 1984 Bluebook also makes it clear that the statutory reserve cap, like the section 809 differential earnings amount determination, includes deficiency reserves. With regard to the cap, the 1984 Bluebook specifically states:

> In no event will the amount of the tax reserves at any time exceed the amount of statutory reserves, which (given the general definition thereof in new sec. 809(b)(4)(B)(i)), include also any deficiency reserves relating to the liabilities.[7]

This quote clearly indicates that Congress intended the statutory reserve cap, by cross-reference to the section 809(b)(4)(B)(i) definition, to include deficiency reserves. This conclusion reflects settled law and is endorsed in the Internal Revenue Manual instructions for calculating the section 807(d) tax reserve, which provide as follows:

> However, in the comparison to the statutory reserve, any deficiency reserve included in the contract's statutory reserve is allowed to be included for purposes of the maximum FPR limitation.[8]

In the 1993 FSA, however, the National Office attorney relied on a wrinkle in legislative history of the 1986 Technical Corrections to the 1984 Act that affected section 816 and former section 809 to conclude that Congress intended to exclude deficiency reserves from the statutory cap. A brief explanation of the technical corrections is necessary to understand the FSA's position, and why it is incorrect. Contrary to the FSA's conclusion, the technical corrections actually reconfirm Congress' intent to include deficiency reserves in the cap. In the 1986 Act, Congress made technical corrections to the 1984 Act to ensure that deficiency reserves would be excluded from the life insurance company

... the Joint Committee on Taxation's Staff Report (1984 Bluebook) makes it clear that Congress wanted to make sure that statutory reserves for this purpose included deficiency reserves.

qualification test under section 816 and to clarify that deficiency reserves should not be double counted in determining the equity base under former section 809. The change to section 816 added subsection (h), which specifically provides that deficiency reserves are excluded from life insurance reserves "for purposes of this section [the life insurance company qualification test] and section 842(b)(2)(B)(i) [the definition of United States surplus of a foreign company insurance doing business in the United States]." The obvious negative inference from section 816(h)'s limited application to the life insurance qualification and foreign company surplus provisions is that deficiency reserves are included for other purposes, such as the statutory reserve cap under section 807(d) and the calculations underlying the policyholder dividend deduction offset for mutual companies under former section 809.

The negative inference from the limited scope of section 816(h) becomes more obvious on consideration of the changes to former section 809. The original version of section 809 created a potential problem of double counting. Deficiency reserves were included in the adjustment to a mutual company's equity base for aggregate statutory reserves in former section 809(b)(4)(A)(i) and then added a second time by former section 809(b)(5). To correct this problem, Congress amended former section 809(b)(2) to provide that no item shall be taken into account more than once in adjusting the equity base. The Joint Committee on Taxation's Staff Report on the technical changes explains that this change was designed to avoid the double counting of deficiency reserves, which, the report specifically notes, are included in aggregate

continued 16

[5] Former section 809(b)(4)(B)(i).

[6] Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984, 615-616 (Comm. Print 1985) (1984 Bluebook).

[7] 1984 Bluebook at 598.

[8] IRM sec. 4.42.4.6.3(6)(d)(Revised May 2002).

The Statutory Reserve Cap on Tax Reserves …
from pg. 15

statutory reserves in section 809(b)(4)(A)(i).[9] Because the statutory reserve cap in section 807(d) originally was defined by cross reference to the definition of "statutory reserves" in former section 809(b)(4)(A)(i), the unmistakable conclusion from the double-counting correction is that deficiency reserves are included for purposes not only of section 809, but also for the statutory reserve cap in section 807(d). The technical correction adding section 816(h), which is specifically limited to the life insurance qualification and foreign company United States surplus determinations, should not be read to cast doubt on this conclusion.

The FSA, however, relied on a deletion in the Senate Finance Committee report regarding the new subsection 816(h), to conclude that the subsection, in spite of its self-limiting language, also applied to the statutory reserve cap in section 807. The House Committee Report underlying the technical correction that added section 816(h) contains a definitive statement that deficiency reserves are included in statutory reserves for purposes of the statutory reserve cap comparison.

> Likewise, this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of any increase or decrease in life insurance reserves.[10]

The Senate Finance Committee report discussion of the new section 816(h), however, omits the "likewise" sentence regarding the statutory reserve cap in section 807(d).[11] The 1993 FSA noted that a Joint Committee Staff Report pertaining to section 807(d) also contained the sentence quoted above that deficiency reserves are to be included in the statutory cap. Nevertheless, the FSA discounted the Joint Committee Staff report and concluded that the omission in the Senate Finance Committee Report created a negative inference that Congress changed its mind and intended to omit deficiency reserves from the statutory cap.

There are a number of reasons why the 1993 FSA is incorrect, in addition to the fact that it contradicts the current IRS position as stated in the Internal Revenue Manual. Most fundamentally, as mentioned above, statutory reserves for purposes of the cap in section 807(d)(1) were originally defined in former section 809. The 1984 Act legislative history directly on point is unequivocal that statutory reserves include deficiency reserves for this purpose. The 1986 Act technical corrections to section 816 did nothing to change the treatment of deficiency reserves in sections 807 and 809 (other than to reconfirm that deficiency reserves are included in statutory reserves under section 809). Instead, the plain language of section 816(h), added by the technical correction in the 1986 Act, is that the new exclusion of deficiency reserves is solely for purposes of sections 816 and 842. There is no ambiguity in the statute that would give rise to the need to look at legislative history in the first place. The FSA improperly relied on a perceived ambiguity in the legislative history pertaining to section 816(h) to contradict not only the plain language of section 816(h), but also a clear statement in earlier legislative history of section 807(d).

The second problem with the FSA's analysis is just as fundamental—the FSA's survey of legislative history is incomplete. As noted above, the House Committee Report for the technical correction contains a clear statement the "this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of any increase or decrease in

[9] Staff of the Jt. Comm. on Tax'n, 100th Cong., 1st Sess. Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation 85 (Comm. Print 1987).

[10] H.R. Rep. No. 99-426, 99th Cong. 1st Sess. 956 (1985) (1985 House Report).

[11] S. Rep. No. 99-313, 99th Cong., 2d Sess. 975 (1986) (1986 Senate Report).

life insurance reserves."[12] The Conference Report regarding the technical corrections specifically states that the enacted law follows the House bill and the Senate amendment with respect to common provisions, of which this is one.[13] Thus, the inference the FSA draws from the Senate Finance Committee report was erroneous. Congress adopted the House bill, and its committee report, not the Senate Report.

The FSA's conclusion is wrong for a third reason—it is inconsistent with the related technical correction to section 809. It is precisely because Congress understood the meaning of statutory reserves under section 809 (and section 807) to include deficiency reserves that it became necessary to include the correction to prohibit double counting in the equity base determination under section 809, and both the House Report and the Senate Report on which the FSA relies specifically acknowledge this point.[14]

The FSA also reflected a misunderstanding of why the technical correction adding section 816(h) was necessary. Congress recognized that changes in the NAIC Standard Valuation Law in 1976 made it clear that deficiency reserves are part of life insurance reserves defined in section 816(b). The 1976 amendment to the Standard Valuation Law incorporated deficiency reserves within the prescribed CRVM method. Thus, the case law that had held that deficiency reserves were additional reserves not held for future claims was no longer controlling. This is why section 807(d)(3)(C) was added to the Code to exclude deficiency reserves from the FPR and why a technical correction was needed to exclude deficiency reserves in section 816(h). Thus, Congress correctly understood that deficiency reserves are included in the statutory cap because, without a statutory exclusion, they satisfy the general definition of life insurance reserves as in section 816(b). Thus, the enactment of the technical correction to section 816(h) in 1986 Act served to reconfirm conclusively that deficiency reserves are included in the statutory cap.

Perhaps the Senate Finance Report deleted the reference in the section 816(h) explanation to the section 807(d) statutory cap simply because the existing law was not ambiguous and the sentence was not germane to the technical correction, which did not relate to section 807. The deletion, however, cannot reasonably lead to a conclusion that deficiency reserves are excluded from the statutory cap.

This is one instance where a conclusion in an FSA is simply wrong and does not represent current IRS position. Hopefully, it will no longer be relied upon by IRS examiners to propose adjustments on audit.

Samuel A. Mitchell is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *smitchell@scribnerhall.com.*

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

[12] Supra.

[13] Conf. Rep. 99-841, 99th Cong., 2d Sess. 841, Vol. II (1986).

[14] 1985 House Report at 948; 1986 Senate Report at 968.

Removal of Profit/Loss Separation Rule from Life/Nonlife Regulations Eliminates Tax Issue from Securitizing Triple-X Business

by Michael A. Bell

There are numerous important tax issues that arise in the securitization of Triple-X life insurance business by consolidated groups that include both life insurance companies and other companies (insurance and otherwise), *i.e.*, life/nonlife consolidated groups. Among these issues are questions about the effect of the Interal Revenue Service (IRS) regulations governing the conditions under which a life/nonlife consolidated group can file a consolidated federal income tax return. Recently, the IRS eliminated one of the more amorphous tax rules that at times was a stumbling block in Triple-X securitization transactions. Unfortunately, however, the IRS left an equally amorphous consolidated return rule untouched.

Background

In 1999, the NAIC adopted Valuation of Life Insurance Policies Model Regulation, more commonly known as Regulation Triple-X, a statutory reserving method for certain life insurance products. In brief, Regulation Triple X requires life insurance companies to establish statutory reserves well in excess of expected losses from level premium term life insurance business. That requirement can cause substantial surplus strain for affected life insurance companies, and for that reason, many life insurance companies that write level premium term life insurance business have sought to securitize their Triple-X business.

In its most basic form, the securitization of Triple-X life insurance business entails (1) the establishment of a life insurance subsidiary that is not subject to the Triple-X reserving requirements; (2) the cession of the Triple-X business from the parent life insurance company to the newly established subsidiary; and (3) the issuance by the life insurance subsidiary (or a holding company) of debt in the capital markets to fund the subsidiary's surplus requirements.

In many cases, life insurance companies that securitize their Triple-X business are members of groups of corporations that include other types of corporations as well ("nonlife" companies) for purposes of filing federal income tax returns. Traditionally, life insurance companies were not permitted to join nonlife companies in filing consolidated federal income tax returns. That prohibition was eliminated, however, when Congress enacted section 1504(c)(2) of the Internal Revenue Code,[1] giving life insurance companies permission to consolidate with nonlife companies beginning in 1981. In 1983, the IRS finally issued regulations (the "life/nonlife" consolidated return regulations) containing various requirements for life insurance companies that sought to join in a life/nonlife consolidated return.

The life/nonlife consolidated return regulations were drafted in terms of the somewhat complicated system by which life insurance companies were taxed at the time, which entailed three "phases":

- Phase I—A life insurance company's tax base was the lesser of the company's "gain from operations" or its "taxable investment income."
- Phase II—If a life insurance company's gain from operations exceeded its taxable investment income, 50 percent of the excess was added to the tax base.
- Phase III—An amount equal to the other 50 percent of the excess of gain from operations over taxable investment income was added to the life insurance company's "policyholders surplus accounts." Amounts added to a company's policyholders surplus account were taxed when distributed to a company's stockholders.

In 1984, Congress completely revised the system for taxing life insurance companies, eliminating the three-phase system in favor of tax rules substantially like those that apply to corporations generally. *See generally* Tax Reform Act of 1984, Pub. L. No. 98-369. As a result, however, some of the 1983 life/non-life consolidated return regulations became difficult to apply, and the rationales underlying others seemed no longer valid. Nonetheless, the regulations were not revised and are still in effect.

Under the life/nonlife consolidated return regulations, before a life insurance company is permitted to join in filing a life/nonlife consolidated return, it must have satisfied certain affiliation requirements during the five preceding taxable years of the parent of the consolidated group, a period called the "base" period. Thus, throughout the base period, the life insurance company:

- Must have been in existence and have otherwise been a member of the consolidated group, engaged in the active conduct of a trade or business.
- Must not have experienced a change in its tax character, *i.e.*, the Code provision under which it is taxed, as the result of an acquisition of assets from outside the group in one or more transactions not conducted in the ordinary course of its trade or business; and
- Must not have undergone a disproportionate asset acquisition attributable to the acquisition of assets from outside the group in transactions not conducted in the ordinary course of its trade or business.

A life insurance company that satisfies those requirements is referred to as an "eligible" life insurance company, and upon satisfying the requirements must join in the life/nonlife consolidated return for as long as the life insurance company remains eligible.[2]

Thus, in a typical Triple-X securitization, a life insurance subsidiary that is formed by a member of a life/nonlife consolidated group must satisfy these eligibility requirements for the base period in order for its losses to be used by other members of the group. Taking five years to do so, however, would significantly impair a good number of securitizations.

The Tacking Rule

Fortunately, the life/nonlife consolidated return rules contain a provision that can substantially accelerate the satisfaction of the eligibility requirements. The provision, called the "tacking rule," applies to a life insurance company that is formed from within a life/nonlife consolidated group by one or more eligible life insurance company members of the group. Under the tacking rule, the newly formed life insurance subsidiary is treated as a having satisfied the eligibility requirements to the extent that the forming member has satisfied them. Briefly stated, the requirements are:

- At any time, at least 80 percent of the assets that the newly formed life insurance subsidiary has acquired outside of the course of its ordinary trade or business must have been acquired from an eligible member of the group in a tax-free transaction.
- Both the forming member and the newly formed life insurance subsidiary must be taxable as life insurance companies.
- The new subsidiary must not have undergone a disproportionate asset acquisition—at any time during a consolidated return year—that is attributable to one or more "special acquisitions," *i.e.*, must not have undergone a significant acquisition of assets in one or more transactions not conducted in the ordinary course of its trade or business, whether from inside or outside the life/nonlife consolidated group.[3]
- Finally, before the withdrawal of this requirement —as discussed above—if both the forming member and the new subsidiary are life insurance companies, the transfer should not have reasonably been expected to separate profitable activities from loss activities.

> The tacking rule is frequently used in Triple-X securitizations to accelerate the eligibility of life insurance subsidiaries.

The tacking rule is frequently used in Triple-X securitizations to accelerate the eligibility of life insurance subsidiaries.

Prohibition against Separating Profit Activities from Loss Activities.

There are two elements of the tacking rule that are notable for their elusive meaning: (1) the rule against separating profitable activities from loss activities and (2) the meaning of a life insurance company's "ordinary course of business." The IRS has now withdrawn the rule prohibiting the separation of profits and losses. Its rationale for doing so is based, first, on

continued 20

… Triple-X business can be expected to become profitable sometime in the future, and there is no guidance about when (if ever) the separation of profits and losses might occur without creating a problem under the regulations.

the extensive revisions to the system of taxing life insurance companies made in 1984, and, second, on the provision in the American Jobs Creation Act of 2004, Pub. L. No. 108-357, by which Congress permitted the tax-free distribution of policyholders surplus account balances. The IRS and the Treasury Department concluded that these two developments, taken together, have rendered the rule prohibiting separation of profits and losses "no longer relevant under current law."[4] T.D. 9258 (Apr. 24, 2006).

The separation of profits and losses rule was somewhat troublesome for tax practitioners involved in Triple-X securitizations. The Triple-X business is generally expected to generate significant losses in the early years, and the ceding company's retention of the Triple-X business could cause the ceding company significant surplus strain, hence the need for the securitization. In one light, therefore, the cession of Triple-X business to a newly formed subsidiary could be considered to result in the separation of profit activities from loss activities. The Triple-X business would generally be expected to cause more-or-less the same losses for the ceding company as it would for the newly formed life insurance subsidiary, and on that basis, the separation of profits and losses rule should not apply. Confusing matters further, the Triple-X business can be expected to become profitable sometime in the future, and there is no guidance about when (if ever) the separation of profits and losses might occur without creating a problem under the regulations. For these and other reasons, the IRS's withdrawal of the rule from the life/nonlife consolidated return regulations is a welcome development.

Definition of "Ordinary Course"

As welcome as the withdrawal of the separation of profits and losses rule is, it is unfortunate that the IRS did not use the opportunity to define an equally ambiguous phrase, *i.e.*, the ordinary course of a life insurance company's trade or business, which is used in the general eligibility requirements as well as in the tacking requirements. Both the 80 percent test and the disproportionate asset acquisition rule refer to the ordinary course of business, but the regulations make no attempt to define the term.[5]

The IRS has never explained in any published authority how one might determine what the ordinary course of a life insurance company's trade or business might be.[6] There are at least two ways to view the question. The first, and seemingly more reasonable approach, is to treat as the ordinary course of business anything that a life insurance company might reasonably do to advance its business. In most cases, a license to conduct a life insurance business permits a life insurance company to conduct reinsurance business, as well. No additional license or permission is needed. On that basis, the assumption of Triple-X business by a life insurance subsidiary in a Triple-X securitization ought to be considered to be in the ordinary course of the subsidiary's trade or business.

Another approach, which the IRS has advocated informally, is that the ordinary course of a life insurance company's trade or business should refer only to those businesses that have been regularly carried on. The difficulty with that approach is that it leaves completely uncertain the point at which a life insurance company's activities become "regularly carried on." In its rulings under the life/nonlife consolidated return regulations, the IRS has steadfastly avoided providing a definition.

For example, in LTR 91-15-028, the IRS ruled that the change in a nonlife insurance company's tax character, caused by the acquisition of life insurance business from outside the life/nonlife consolidated group, did not disqualify the company from being a member of the group, because the acquisition had been in the ordinary course of the insurance company's trade or business. As a condition of issuing a favorable ruling, however, the IRS had insisted that the taxpayer represent that it had regularly entered into reinsurance contracts with other insurance companies (thus enabling the IRS to conclude that the reinsurance had been in the ordinary course of the company's trade of business).[7]

The real question is whether the ordinary course of a life insurance company's business is what a life insurance company is permitted under its charter to do, or rather what the life insurance company has done many times in the past. If it is the latter, one is left wondering just how

many times a life insurance company would have to engage in reinsurance transactions before reinsurance became the ordinary course of life insurance company's trade or business. A more reasonable determination whether a transaction occurs in the ordinary course of a life insurance company's trade or business would be to ask whether company's reinsurance activity is functioning as a going concern and is performing the activities for which it was organized.[8] If so, it would seem that transactions that are permitted under the company's charter should be considered to be in the ordinary course of the company's trade or business. Such a definition would make it easier for newly formed life insurance companies to rely on the tacking rule without impairing any of the safeguards or restrictions that the IRS has incorporated into the life/nonlife consolidated return regulations.

Conclusion

The IRS itself has informally observed that the life/nonlife consolidated return regulations are outmoded and out of date, but undertaking a wholesale revision, the IRS explains, would be an enormous challenge. Moreover, the IRS has explained that it is unlikely to undertake such a challenge because, even though Congress revised the system of taxing life insurance companies in 1984, it did not disturb section 1504(c)(2) which is the Code provision that permits life/nonlife consolidation. As a result, the IRS feels that some regulatory guidance is needed for life/nonlife consolidated returns, even if the existing regulations are not a perfect fit, unless and until Congress repeals section 1504(c)(2).

The IRS's concern is certainly valid, but clarifying a phrase that plays such an important role in the consolidation of life and nonlife companies would not require a wholesale revision of the regulations. Providing a reasonable and workable definition of the phrase "ordinary course of a trade or business" would seem to be a small step that could provide a good deal of clarity, not only for the Triple-X securitization transactions, but also for companies subject to the life/nonlife consolidated return regulations generally.

References

1) Tax Reform Act of 1976, Pub. L No. 94-455, § 1507(a). Except as otherwise designated, all statutory references in this article are references to the Internal Revenue Code (the "Code").

2) Nonlife companies in the life/nonlife consolidated group can also be either eligible or ineligible. That distinction, however, is not relevant to this article.

3) A "special acquisition" occurs for any member of the life/nonlife consolidated group at the end of any taxable year in which at least 75 percent the member's insurance reserves, assets, or premiums are attributable to one or more acquisitions of assets from outside the group in transactions not conducted in the ordinary course of its trade or business. Whether a special acquisition is disproportionate is generally determined at the end of each base period, *i.e.*, at the end of each taxable year of the common parent. If a subsidiary is relying on the tacking rule for its eligibility, however, the disproportionate asset acquisition rule applies at all times during any taxable year of the common parent.

4) The IRS and the Treasury Department included the prohibition against separating profit activity from loss activity in the life/nonlife consolidated return regulations because the IRS and the Treasury Department were concerned that the interplay of the "three-phase" system of taxing life insurance companies and the so-called bottom-line consolidated return method then in effect, could enable life insurance companies to separate profitable activities from loss activities and thereby reduce consolidated life insurance company taxable income. T.D. 9258, *supra*.

5) The phrase "regularly carried on" also appears in the more general eligibility requirements. In order to be included in a life/nonlife consolidated group, a life insurance company must not have had a change in its tax character, *i.e.*, the provision of the Code under which it is taxed, that is attributable during, the base period, to any acquisition of assets in one or more in transactions not conducted in the ordinary course of the company's trade or business. This requirement cannot be satisfied by means of the tacking rule.

6) The tax law is replete with definitions of the phrase "ordinary course of business." *See, e.g., Deputy v. DuPont*, 308 U.S. 488 (1940).

7) *See also* LTR 94-41-021 (same representation and same conclusion). It is important to note, however, that representations by taxpayers do not constitute affirmative conclusions by the IRS.

8) *See generally* 6 J. Mertens, Law of Federal Income Taxation § 25.11.

Michael A. Bell is a partner with the Washington, D.C. law firm of LeBoeuf, Lamb, Greene & Mac Rae, LLP. He may be reached at *mabell@llgm.com.*

The IRS Schedule M-3 for Insurance Companies

by Amy C. Lewis

Insurance companies will be required to file the Internal Revenue Service (IRS) Schedule M-3 for tax years ending on or after Dec. 31, 2006. Schedule M-3 was designed by the IRS as a replacement for the Schedule M-1, which is used to reconcile a corporation's financial accounting income or loss with its taxable income or loss. The purpose of Schedule M-3 is to provide more transparency and consistency among taxpayers than Schedule M-1 in reporting differences in between financial accounting net income and taxable income and to enable the IRS to more effectively and efficiently identify returns and issues warranting examination.

2004 marked the first tax filing year that certain corporate taxpayers were required to file the newly-created Schedule M-3. As provided by the 2004 Schedule M-3 instructions, insurance companies were not required to file Schedule M-3, unless an insurance company was a member of a consolidated group whose parent corporation filed a Form 1120 and was required to file Schedule M-3. Insurance companies who filed as part of a consolidated return had the option of fully completing Schedule M-3 as if the insurance company filed a Form 1120, or by including the sum of all the differences between the insurance company's financial accounting net income and taxable income on a single line of the M-3, and adequately disclosing each difference in a supporting schedule.

On Dec. 13, 2005, the IRS released the first drafts of the 2006 Schedules M-3 and related instructions for corporations that file Forms 1120-PC and 1120-L, along with draft Schedules M-3 for partnerships and S-corporations. The original draft schedules and instructions for the Schedules M-3 for Form 1120-PC and 1120-L filers were based on the draft 2005 Schedule M-3 for Form 1120 filers and instructions released for comment by Treasury and the IRS on June 23, 2005.

After receiving comments on the first drafts, the IRS released revised draft Schedules M-3 and instructions for Forms 1120-PC and 1120-L in April 2006. In addition to the revised draft M-3s, the IRS also released a draft of a new Form 8916, "Reconciliation of Schedule M-3 Taxable Income with Tax Return Taxable Income for Mixed Groups," which is designed to provide a means for consolidating and reconciling taxable income for corporations that include both an insurance company and a non-insurance company, or two different types of insurance companies, such as life insurance and property and casualty insurance. The IRS announced it was seeking comments regarding the revised draft M-3s, Form 8916, and related instructions through June 1, 2006. It is likely that the IRS will issue revised forms and instructions based on the comments received.

Once the IRS finalizes the new insurance Schedules M-3, the following corporations will be required to use Schedule M-3 for Forms 1120-PC or 1120-L in lieu of the previous Schedule M-1 or Schedule M-3 for Form 1120, beginning with tax years ending on or after Dec. 31, 2006:

- An insurance corporation filing a separate return with total assets of $10 million or more;
- A consolidated return group with an insurance parent corporation, with total consolidated assets of $10 million or more;
- Insurance subsidiaries that have been required to partially complete Schedule M-3 (Form 1120) because they are included in a Form 1120 consolidated return that is required to file Schedule M-3.

During the first year that taxpayers will be required to file these new insurance Schedules M-3, the reporting of detail for columns (a) and (d) of Parts II and III will be optional, as was the case with Schedule M-3 for first year Form 1120 filers. However, this will only apply to the

first two groups of corporations above; insurance subsidiaries included in a consolidated Form 1120 will be required to complete all columns of Parts II and III, as they were required to file Schedule M-3 in years prior to Dec. 31, 2006. The instructions also have been modified to clearly indicate that Schedule M-3 is required to be filed if the threshold amount is met, whether or not a consolidated return is filed.

Part I is the same for all three Schedules M-3. Several new lines were added in Parts II and III of each insurance Schedule M-3 to reflect insurance-specific income and expense items, such as premium income, tax reserves, policy acquisition costs, and the special loss discount account. Additionally, some lines were eliminated because they either do not apply to insurance corporations or are considered low risk items as to insurance corporations. Those items that the IRS considers to be of lower compliance risk are to be reported in sufficient detail in the supporting schedules for the "other" with differences lines.

While the Schedules M-3 are designed to present a more detailed reconciliation than the previous Schedule M-1, there may actually be less disclosure for some differences reported in columns (b) and (c) of Parts II and III than previously reported on Schedule M-1. For example, if an insurance corporation on its 2005 return reports three separately described adjustments associated with interest income on its Schedule M-1, to report those same adjustments on Schedule M-3 with a 2006 return, the amounts would be combined together and reported as a lump sum in columns (b) and/or (c) of Part II, line 13, with no detail or supporting schedule required. This result is true for many of the named lines on Schedule M-3; however, there are several lines that still require supporting schedules. The instructions provide that for these lines, such as for Part II, line 25, "Other income (loss) items with differences," each difference must be "separately stated and adequately disclosed." It is important to remember that for any line that does not require detail with the return, supporting information must still be available in the corporation's records so as to respond to examination or inquiry by the IRS.

The draft Schedules M-3 and Form 8916 deal with several previously unaddressed issues for corporate taxpayers who file a consolidated tax return that includes a combination of Forms 1120, 1120-PC, and/or 1120-L. Page 1 of the revised draft Schedule M-3 for Forms 1120, 1120-PC and 1120-L has a checkbox to indicate if a corporation is filing as part of a mixed group. Checkboxes have also been added at the top of pages 2 and 3 of the Schedule M-3s to indicate when an M-3 is for a group sub-consolidation or elimination, as a separate group sub-consolidation is required for all Forms 1120, 1120-PC, 1120-L, within the mixed group.

The new Form 8916, allows a mixed group a means for consolidating and reconciling taxable income. The Form is designed to reconcile consolidated taxable income from the Schedule M-3 to taxable income reported on the consolidated tax return. Amounts to be reported on Form 8916 include such items as net operating loss deduction, dividends received deduction, special life deductions, and life/non-life loss limitations. Currently, the draft form and instructions require that any amounts reported as other adjustments require supporting schedule and short explanation of the amounts to be attached.

Even though insurance corporations will receive the benefit of knowledge learned from the experiences of C corporations in implementing Schedule M-3, they will still be faced with potentially significant upfront costs for implementation. Since the IRS is not requiring any new Schedules M-3 for years ended Dec. 31, 2005, giving all other LMSB taxpayers at least an additional year to prepare, it is unlikely the IRS will entertain deferral of the effective date for insurance corporations. Companies should plan for the additional amount of work and resources in connection with next year's implementation of new Schedules M-3.

Additionally, it seems likely that some changes will be made to Page 1 of Form 1120-L to allow for a subtotal of income before special deductions. In this way, the Schedule M-3 reconciliation total for Form 1120-L would be comparable to the reconciliation totals for Forms 1120-PC and 1120, which would aid in the preparation of a consolidated M-3 and reconciliation of taxable income for mixed filing groups.

The draft Schedules M-3, Form 8916 and instructions can be found in the business section of *www.irs.gov*, on the Corporations page. The Web site also offers interested taxpayers a subscription to the Schedule M-3 e-mail news service so they can automatically receive future information about Schedule M-3. ◂

Amy C. Lewis is manager with Ernst & Young's Lake Michigan Insurance Tax Practice in Chicago, Ill. She may be reached at *Amy.Lewis@ey.com.*

When Are Guaranty Association Assessments Deductible?

by Peter H. Winslow and Lori J. Jones

Under SSAP No. 35, a liability for guaranty fund assessments must be charged to expense (Taxes, Licenses and Fees) when an insolvency giving rise to a potential assessment has occurred. The amount reported as a liability is the best estimate of the insurer's share of the ultimate loss expected from the insolvency, taking into account the best available information about market share and premiums by state and line of business. Where state law allows a credit for future state premium taxes, the liability is established gross of the probable recovery, with the potential recovery through premium tax credits reported as a separate asset.

In *Principal Life Insurance Company v. United States*, 97 AFTR 2d 2006-1542 (U.S. Ct. Fed. Cl. 2006), the question came up as to whether the insurer was entitled to a current deduction for the portion of the guaranty fund assessments that were potentially available for future premium tax credits. On its tax returns, Principal deducted the guaranty fund assessments on a cash basis, but initially capitalized and amortized the portion available for premium tax credits over the period for which the credits were available. This position conformed to the historic informal position of the Insurance Branch of the IRS National Office. Principal decided to challenge this position and filed claims for refund and a Form 3115 (Application for Change in Accounting Method) to reverse the capitalization treatment. Principal's argument was that the assessments were taxes deductible in full under I.R.C. § 164 for which no capitalization is required.

The Court of Federal Claims rejected Principal's position and held that guaranty association assessments are not taxes for federal income tax purposes. This holding of the court has support in the case law. A tax is "a levy and collection of revenue without relationship to a specific governmental privilege or service." *Cox v. Comm'r*, 41 T.C. 161, 164 (1963). The Court of Federal Claims concluded that the assessment was a regulatory fee as opposed to a tax based on, among other things, the fact that: (i) assessments were imposed by the board of the guaranty association (*i.e.*, not a legislative body or state agency); (ii) the class of those assessed is relatively narrow; and (iii) the assessments are segregated from the revenues of the state and benefit only a very discrete segment of the public (*i.e.*, the guaranty association itself and possibly the insolvent insurer). Although guaranty fund assessments are not taxes, it does not necessarily follow that any portion of the assessments are required to be capitalized. In general, under case law, an amount is required to be capitalized under I.R.C. § 263 if there is a significant future benefit. The fact that a premium tax credit may be available in the future does not necessarily translate to such a benefit. The court did not reach this question, however, apparently because it was not timely raised by the taxpayer.

Regardless of the merits of the decision in *Principal Life*, in effect, it has been overruled by the promulgation of Treas. Reg. § 1.263(a)-4 generally for 2004 and later years. These regulations were intended to eliminate disputes over capitalization by setting forth bright-line criteria for capitalization of amounts paid to acquire or create an intangible asset. Importantly, if the regulations do not specifically require capitalization of a particular expense, and it otherwise qualifies as a trade or business expense, it is currently deductible. T.D. 9107, 2004-1 C.B. 447. Because the regulations do not specifically require capitalization of guaranty fund assessments, beginning with the effective date of the regulations for amounts paid or incurred on or after Dec. 31, 2003, they are deductible despite the holding in the Principal Life case.

Another potential issue not addressed in Principal Life is whether the insurer was correct that guaranty fund assessments are required to be deducted on a cash basis. Non-life insurance companies other than companies subject to I.R.C. § 833 (generally Blue Cross/Blue Shield plans) are entitled to deduct premium-based guaranty fund assessments as premium acquisition expenses on a reserve basis even before they are accrued under the all-events test, and even in some cases before

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

Lori J. Jones is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. She may be reached at *ljones@scribnerhall.com.*

there is an insolvency and they are reported on the Annual Statement. Rev. Proc. 2002-46, Sec. 3.01, 2002-2 C.B. 105. This rule does not apply to life insurers.

A deduction prior to payment is available to a life insurer only if it can be successfully argued that the liability is included in reserves for unpaid losses based on the theory that the insurer is acting in the capacity as a reinsurer of insolvent companies, or the liability satisfies both the all-events test and economic performance rules for accrual. It is ironic in light of the parties' arguments in Principal Life that it is IRS auditors who usually argue that guaranty fund assessments are taxes because Treas. Reg. § 1.461-4(g)(6) provides that economic performance occurs for taxes only upon payment. One potential argument to avoid a cash method is that an insurer is providing a service to the state promising to satisfy insolvent insurer's claims so that economic performance is satisfied when these services are performed (i.e., the guaranty is made). See Treas. Reg. § 1.461-4(d)(4). Even if this argument is successful, however, the insurer first has to demonstrate that the amount of its liability is fixed and reasonably susceptible to estimation. Because of the uncertainty of these rules, when the accrual issue comes up on audit, it sometimes is settled at IRS Appeals on the basis of allowing the company a deduction for the amounts actually paid within 8 one-half months after the end of the taxable year (I.R.C. § 461(h)(3)(A)), or the insurer agrees to adopt the cash method as a trade-off for an IRS concession on another issue. Therefore, even with the Principal Life decision, the timing of the deduction of guaranty association assessments for life insurers is still uncertain. ◂

REMINDER • REMINDER • REMINDER • REMINDER

Product Tax Seminar

Space Still Available!

On-site Registration!

Washington, D.C.
September 11-13, 2006
Sponsored by the SOA Taxation Section

Day 1:
Optional "Boot Camp" providing an intense introduction to the basics of product taxation. Choose between Boot Camps focused on:

- Life Insurance
- Annuities & Long-Term Care

Days 2 and 3:
General sessions covering current product tax issues.
Featured products include:

- Life Insurance
- Annuities
- Long-term Care
- Combination Products

The IRS will be invited to participate in this seminar and share their views and perspectives on many of the issues facing our industry.

Register on-line at **www.soa.org**
or on-site at the seminar!

REMINDER • REMINDER • REMINDER • REMINDER

T³: *Taxing Times* Tidbits

IRS Provides Insight at FBA's Insurance Tax Seminar Regarding Further Guidance with Respect to Closing Agreements Covering Life Insurance Contracts

by Craig R. Springfield, Daniela Stoia and Lori A. Robbins

Craig R. Springfield is a partner with the Washington, D.C. law firm of Davis & Harman LLP. He may be reached at *cspringfield@davis-harman.com.*

Daniela Stoia is a partner with the Washington, D.C. law firm of Davis & Harman LLP. She may be reached at *dstoia@davis-harman.com.*

Lori A. Robbins is an associate with the Washington, D.C. law firm of Davis & Harman LLP. She may be reached at *larobbins@davis-harman.com.*

On June first and second, the Federal Bar Association and the Office of Chief Counsel, Internal Revenue Service (IRS) held their annual Insurance Tax Seminar. At the seminar, members of Branch 4, Financial Institutions & Products, Internal Revenue Service (the Insurance Branch) described three major projects they are working on to enable taxpayers to seek relief more efficiently with respect to (1) life insurance contracts that do not satisfy the requirements of IRC section 7702 (failed contracts) and (2) inadvertent modified endowment contracts (MECs).

Correcting Failed Contracts - Model Section 7702 Closing Agreement

In Rev. Rul. 91-17, 1991-1 C.B. 190, the IRS set forth the terms under which it would agree to correct failed contracts. If the error that gave rise to the failed contracts was not due to reasonable error within the meaning of section 7702(f)(8), a taxpayer would be required to enter into a closing agreement (*i.e.*, contract) with the IRS to correct the failed contracts. Under such a closing agreement, a taxpayer would be required to pay an amount equal to the tax the policyholders would have owed if they were treated as receiving the income on the contracts of the failed contracts (*i.e.*, the gain or inside buildup) and deficiency interest on such tax.

While companies could only request closing agreements from the IRS, pursuant to Rev. Rul. 91-17, prior to June 3, 1991, the IRS nonetheless continued entering into closing agreements with taxpayers to correct failed contracts after that date. More recently, the IRS issued Notice 99-48, 1999-2 C.B. 429. That Notice informs taxpayers that the IRS will continue entering into closing agreements pursuant to the terms described in Rev. Rul. 91-17, and sets forth the tax rates to be used to determine the amount owed under such closing agreements.

At the FBA, members of the Insurance Branch described the branch's efforts to draft a "model" closing agreement so that taxpayers seeking a closing agreement to correct failed contracts may do so more efficiently. (A similar model closing agreement is available in section 6 of Rev. Proc. 2001-42, 2001-2 C.B. 212, for taxpayers seeking to correct inadvertent MECs). It appears that the new section 7702 model closing agreement will be a standard contract between a taxpayer and the IRS that will set forth the terms under which the IRS will allow taxpayers to correct failed contracts. The Insurance Branch did not provide any information about when the model would be made available to taxpayers.

Model Rev. Rul. 2005-6 Alternative C Closing Agreement

Last year the IRS issued Rev. Rul. 2005-6, 2005-1 C.B. 471, which held that for purposes of sections 7702 and 7702A, charges imposed with respect to qualified additional benefits (QABs) should be treated as "expense charges" pursuant to section 7702(c)(3)(B)(ii). After Feb. 7, 2006, taxpayers desiring to correct failed contracts that resulted from their improper accounting for QAB charges must request from the IRS a closing agreement pursuant to Alternative C of the "Application" section of Rev. Rul. 2005-6. Members of the Insurance Branch informed taxpayers that the branch was in the process of drafting a model Alternative C Rev. Rul. 2005-6 closing agreement to be used by taxpayers seeking relief for their failed contracts under Alternative C of Rev. Rul. 2005-6.

Rev. Proc. 2001-42 - Changes Considered

Members of the Insurance Branch also discussed two potential changes to Rev. Proc. 2001-42 that the branch

is considering. The first change is a clarification of the indices to be used to calculate the "earnings rates" under section 3.07 of Rev. Proc. 2001-42. The second change would be to allow taxpayers to submit the information required under Rev. Proc. 2001-42 with respect to their inadvertent MECs on CD-ROM rather than paper. Members of the Insurance Branch stated that they would appreciate comments from taxpayers with respect to these proposed changes.

Update on Principles-Based Reserves
by Donna K. Weninger, FSA, MAAA

The May 2006 edition of *Taxing Times* contained several articles discussing the proposed principles-based approach (PBA) for life insurance reserves. As discussed in these articles, there are a number of serious tax-related questions surrounding the application of a PBA that remain unresolved.

On June 8, 2006, the NAIC's Life and Health Actuarial Task Force (LHATF) met, issuing drafts of the Principles-Based Reserves for Life Products Model Regulation and three Actuarial Guidelines that were exposed for comment. The Actuarial Guidelines are: principle-based life reserving, life reserve assumption margins, and life reserving disclosure. These draft documents are available on the American Academy of Actuaries (AAA) Web site at *www.actuary.org*.

Highlights of these drafts include the following recommendations:

1. The PBA for life reserves should be applied on a prospective basis only. A determination for the retroactive application of PBA to in-force policies may be decided upon at a later point in time.

2. The Gross Premium Valuation method should be used to calculate the deterministic reserve.

3. The Greatest Present Value of Accumulated Deficiencies method should be used to determine the stochastic reserve.

At the meeting there was general support for the Life Reserves Work Group (LRWG) recommendations on determining assumption margins. Specifically, determining margins will be left to the professional judgment of the actuary, rather than imposing prescribed number limits, caps, or ranges on margin levels. Additionally, robust guidelines will be provided in Actuarial Standards of Practice, Actuarial Guidelines, and regulations to identify the considerations and procedures that the actuary must follow when determining assumption margins. The LRWG remains committed to having the PBA finalized and ready for adoption by the NAIC in December 2006, with rollout to the states for their adoption in 2007.

Because many of the serious tax-related questions surrounding the application of principles-based reserves remain unresolved, LHATF continues to look at these matters and get new information from various sources.

The recommendations put forth by LHATF represent their current thinking on these issues. Because many of the serious tax-related questions surrounding the application of principles-based reserves remain unresolved, LHATF continues to look at these matters and get new information from various sources. As such, it may reconsider some of these tentative decisions itself. To keep abreast of the latest developments visit the AAA Web site which provides an update for all PBA projects and links to more detailed documents.

E-filing Updates for the Insurance Industry
by Steven M. Greene and Gregory L. Stephenson

General IRS E-filing Requirements Update

There have been a number of changes to the e-filing requirements of corporations since the IRS first released temporary and proposed regulations on Jan.12, 2005 (see article outlining the details of these regulations in the May 2006 issue of *Taxing Times*). On May 30, 2006, IRS again released temporary and proposed regulations that simplify, clarify, or eliminate reporting burdens and also eliminate regulatory impediments to the electronic filing of certain statements that taxpayers are required to include on or with their federal income tax returns. In particular, for insurance companies that file their federal returns electronically, an exception exists that eliminates the requirement that a PDF copy of the annual statement be filed with the return. This will significantly reduce the number and size of PDF files required to be attached.

Due to advances in efficiencies of commercially available software, corporate taxpayers can now file all their international forms in the PDF file format. Further, the IRS eliminated this e-file requirement; now, all

continued 28

Donna K. Weninger, FSA, MAAA, is a manager with Deloitte Consulting, LLP in Hartford, Conn. She may be reached at *dweninger@ deloitte.com.*

Steven M. Greene is senior manager, Insurance Tax Services with Smart and Associates, LLP in the Devon, Pa. office. He may be reached at *sgreene@smartllp.com.*

Gregory L. Stephenson is partner, Insurance Tax Services with Smart and Associates, LLP in the Devon, Pa. office. He may be reached at *gstephenson@smartllp.com.*

These discussions have also focused on the ability of larger groups predominently comprised of insurance companies filing life/non-life consolidated returns to obtain a waiver due to the practical, if not actual, impossibility of e-filing.

corporate taxpayers required to e-file have the option of filing their international forms in PDF format or on paper. The IRS has previously identified (and published) several situations that generally will result in a waiver pursuant to Notice 2005-88. These include 1) a taxpayer that has a business need to file a subsequent return for the same period prior to the extended due date of the return, 2) a taxpayer that has filed a petition for bankruptcy under Chapter 7, 3) taxpayer filing a final return due to a corporate dissolution, merger or acquisition and 4) a taxpayer who was subject to a catastrophic events and continues to incur un due hardship. Waivers granted to corporate taxpayers are generally not published by the IRS.

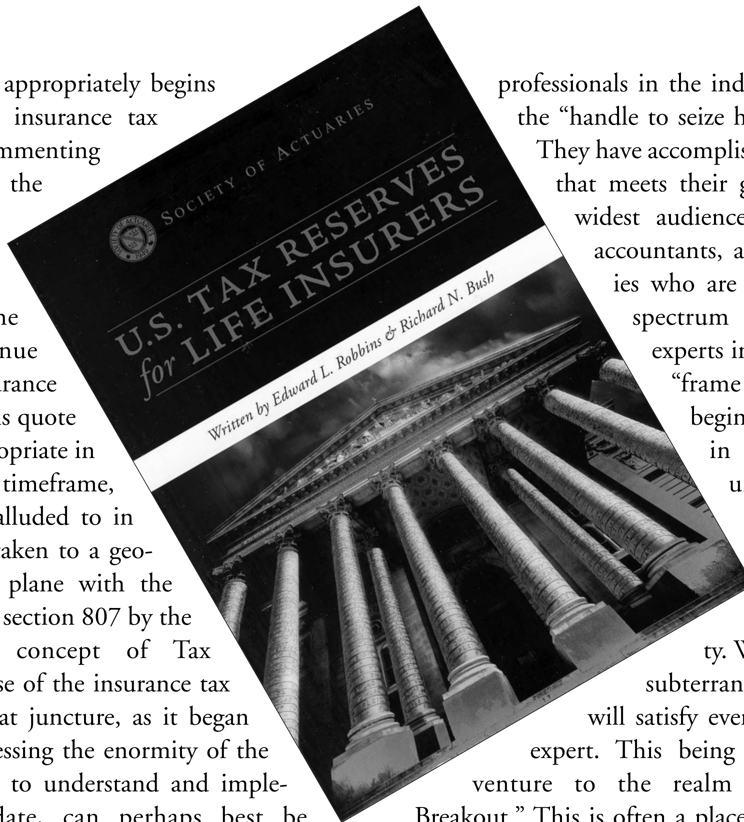
Update on E-filing Impact on Insurance Companies
As previously reported in the May 2006 issue of *Taxing Times*, Section 2 of the optional procedures (published by the IRS as "Tax Year 2005 Directions for Corporations Required to e-file") specifically addresses consolidated groups that file a Form 1120 that include insurance subsidiaries (Forms 1120-PC and 1120-L). Corporations that file a consolidated return that include insurance subsidiaries must file the entire consolidated return electronically with the exception of the Forms 1120-PC and 1120-L, these must be attached as PDF files. These optional procedures highlight the fact that both the IRS and software vendors are not prepared to accommodate and meet the e-filing requirements of large insurance companies.

For consolidated returns (Form 1120) that are predominately comprised of Forms 1120PC and/or 1120L, the majority of the e-filed return will be in the form of PDF files with only the consolidated portion of the return in the required XML-formatted file. In the case where a life/non-life sub-consolidation is required, the top level Form 1120 usually only has lines 30-36 completed with all remaining lines on Page 1 and numerous other schedules blank. Under this scenario, there is some concern that the e-filed return is not a complete and accurate consolidated return. The authors understand that there has been discussion with the IRS National Office by certain insurance companies relative to this concern. These discussions have also focused on the ability of larger groups predominately comprised of insurance companies filing life/non-life consolidated returns to obtain a waiver due to the practical, if not actual, impossibility of e-filing. Apparently, at least one such a waiver has been granted. Do not expect such waiver to be available for the 2006 tax year.

Book Review

U.S. Tax Reserves for Life Insurers, by Edward L. Robbins and Richard N. Bush

by Gregory L. Stephenson



This massive text appropriately begins with my favorite insurance tax related quote commenting on the rarity of the ornithological species that revels in the intricacies of both the Internal Revenue Code and life insurance reserves. While this quote was certainly appropriate in its pre-1984 Act timeframe, the complexities alluded to in its message were taken to a geometrically higher plane with the enactment of IRC section 807 by the 1984 Act—the concept of Tax Reserves. The sense of the insurance tax community, at that juncture, as it began the process of assessing the enormity of the task of beginning to understand and implement this mandate, can perhaps best be explained in the words of Justice Learned Hand. (Justice Hand is the consensus winner of any smartest judge that did not sit on the Supreme Court contest.) He would, no doubt, have characterized tax reserves, as he referred to the then relatively straightforward Internal Revenue Code, as a series of concepts

> … couched in abstract terms that offer no handle to seize hold of [and] leave my mind only a confused sense of something vitally important, but successfully concealed,… which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. *Hand, Eulogy of Thomas Walter Swan*, 57 Yale L. J. 167, 169 (1947).

Now some 22 years after the 1984 Act's enactment there finally is a text that both provides insurance tax professionals with an excellent resource from which to learn as much about this subject as they care to, and defines the complexity and magnitude of that task. Ed Robbins and Richard Bush, two of the most gifted professionals in the industry, have provided the "handle to seize hold of" this subject. They have accomplished this in a manner that meets their goal of reaching the widest audience possible including accountants, attorneys and actuaries who are anywhere along the spectrum from neophytes to experts in the field. They first "frame the topic" at the beginning of each chapter in a manner that is understandable to most, and then progressively drill down to deeper levels of complexity. With most topics, the subterranean levels achieved will satisfy even the most seasoned expert. This being accomplished, they venture to the realm of the "Actuarial Breakout." This is often a place where, with a mere handful of exceptions, non-actuarial experts often quickly lose their equilibrium and find themselves wandering among myriad equations and actuarial symbolism.

The structure of the text is well thought out. The first nine chapters provide background information and build the foundation that facilitates an understanding of the balance of the text. In addition to discussing the basics of tax and statutory reserves, these chapters provide detailed discussion of the various facets of taxable income that are impacted by tax reserves including life insurance company qualification, changes in the basis of computing reserves, and company share computation. These chapters are often referred to in the later chapters where their detailed discussion is appropriate.

Chapter 10 is probably my favorite chapter in the text. It is an introduction to tax reserve planning and documentation. It is not a secret list of the authors' top 10

continued 30

Gregory L. Stephenson is partner, Insurance Tax Services with Smart and Associates, LLP in the Devon, Pa. office. He may be reached at *gstephenson@smartllp.com.*

from pg. 29

This text is a must-have for any practitioner who even occasionally deals with life insurance company tax reserves.

planning ideas, but rather a well thought out detailed list of what needs to be considered by every tax professional who wishes to participate in the tax reserve planning arena. It is written at a level that is both understandable to the person first venturing into this area and yet very useful to the seasoned planner. It first provides excellent lists of the Objectives of Tax Reserve Planning and the Criteria for the Evaluation of such planning. It then goes into some detail relative to other areas that will be impacted such as Statutory Financial Statements, Risk-Based Capital, Deferred Taxes, Surplus, and GAAP Financials. A good background of the Tax DAC (section 848) implications of tax reserve planning is also provided. The chapter concludes with an overview of both external and internal documentation. I may attempt to obtain permission to copy portions of this chapter and offer it as required reading to my colleagues.

The next twenty chapters are the product-specific chapters. These chapters provide in-depth discussion of both statutory and tax reserve methodology relative to most major product lines offered by the life insurance industry. Many contain an Appendix of relevant material, and most contain a detailed Actuarial Breakout. The final two chapters provide an overview of separate accounts, and a detailed discussion of reserve issues relative to reinsurance. These are both extremely relevant subjects and are good additions to the text.

The ability to use this text as well as its usefulness is enhanced by the detailed table of contents, the extensive and expansive footnotes, and the index. The index, however, which contains references to Revenue Ruling's, PLR's, TAM's, FSA's, GCM's, SSAP's, etcetera, perhaps attempts to accomplish too much. The more traditional use of finding lists that could also have included Code and Regulation references could make the book even more user friendly. The glossaries, particularly the first one, are quite useful. This glossary of terms and abbreviations will be particularly beneficial to non-actuarial practitioners who may be new to this area, or who may appreciate an easy way to refresh their memories.

The question of updating this text is, perhaps intentionally, left unanswered. I am sure that the authors needed a bit of time to recover from the Herculean task of assembling this text before making any such commitments. Hopefully they will consider supplemental updates on an as needed basis, perhaps over periods measured in years, not months. This would become extremely critical, however, should a Principles-Based Life Insurance Reserve System be adopted. Answers to questions as to "if" and "how" the existing guidance overlays the new PBR system perhaps could not be answered with any degree of certainty, but the thoughts of the authors, both having lived through the 1984 Act transition period, could provide helpful guidance.

This text is a must-have for any practitioner who even occasionally deals with life insurance company tax reserves. The price, although not inexpensive, is a bargain in terms of time saved, ideas generated, and opportunities salvaged. Although I am certain that the DVD version of the text will be a hit, based on the authors' book unveiling session at last year's Society of Actuaries' Annual Meeting, I would strongly suggest obtaining a copy of the coveted first edition of the print version. It will be a welcome and extremely useful addition to your library. Kudos to the authors on a job well done.

To order a copy, visit: *http://books.soa.org/tax*.

REMINDER • REMINDER • REMINDER • REMINDER

Capital Efficiency Seminar

Register On-site!

Scottsdale, Ariz.

September 19-20, 2006

Co-Sponsored by the SOA Taxtion, Risk Management and Financial Reporting Sections

This seminar will target actuaries and non-actuary CFOs, offering sessions dealing with taxation, embedded value, enterprise risk management and asset-liability management.

The goal of this seminar is to give attendees an awareness of the effect of certain decisions on the economic value of a life insurance company.

The seminar follows the Valuation Actuary Symposium

Register on-line at **www.soa.org** or on-site at the seminar.

Space Still Available!

REMINDER • REMINDER • REMINDER • REMINDER

Society of Actuaries

475 N. Martingale Road
Suite 600
Schaumburg, Illinois 60173
Web: www.soa.org