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The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System

by Joseph F. McKeever, III, John T. Adney and Lori A. Robbins

I. Introduction

The Life Reserve Working Group of the American Academy of Actuaries (the Academy) is developing a new, principles-based reserve valuation standard for life insurance contracts. The Academy recently presented to the National Association of Insurance Commissioners (NAIC) a draft model regulation (the Draft Model Reg) setting forth the fundamental principles and methodologies of a principles-based reserve system.[1] If the NAIC were to adopt some form of the Draft Model Reg, a key issue would be the manner in which such a system would interact with the federal income tax rules governing the deductibility of reserves held by life insurance companies. The adoption by the NAIC, and ultimately by the states, of a new reserve system that contained features in conflict with the federal income tax rules could well prompt the Treasury Department (the Treasury) to ask Congress to revisit and revise those rules, in turn leading to unpredictable and potentially adverse consequences for the life insurance industry. Indeed, the Treasury or Congress on its own initiative, could re-examine the life insurance company tax rules at any time, for any reason, and in times past Congress has rewritten those rules when faced with a significant decline in tax revenues from the industry.

However, the ultimate goal of the Academy's working group appears to be a definition of reserves that represents a more accurate statement of the policyholder liabilities of life insurance companies. Washington tax policymakers share that goal. As shown by the 1984 and 1987 changes in the tax law's reserve rules, the objective of Congress is to allow life insurers to deduct reserves that capture the economic risks associated with their contracts but not to allow a deduction for any excess or redundant reserves that insurers choose to hold.[2] Moreover, a review of those rules demonstrates that both flexibility and resiliency were imbedded into their operation. Hence, barring a significant decline in tax receipts from the industry, neither the Treasury nor Congress should feel compelled to rewrite the federal tax rules on account of the adoption of principles-based reserves. Nevertheless, there are certain items that must be considered in crafting the details of a

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[1] Accompanying the Draft Model Reg were three draft actuarial guidelines: one addressing valuation assumptions, one concerning documentation and disclosure requirements and one setting forth requirements for establishing assumption margins. These draft actuarial guidelines, along with the Draft Model Reg, were presented to the NAIC Life and Health Actuarial Task Force on November 11, 2005, and on December 1 the proposal was presented to the NAIC's "A" Committee. In this article, the concepts in the Draft Model Reg are used as the basis for analyzing the operation of the federal income tax law under a principles-based reserve system.

[2] *See generally* STAFF OF JT. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 596-99 (Comm. Print 1984).

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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

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FROM THE EDITOR

BRIAN G. KING

Welcome readers to a new year of *Taxing Times*! This May issue kicks off our 2006 schedule with plans for two additional issues published later this year. Bolstered by the success and growth of the Taxation Section in 2005, we have planned many additional activities to keep the momentum of our section going and growing. Top on our list for 2006 are a wide array of tax seminars. It is our hope that these seminars will provide tremendous opportunities for exchanging tax knowledge and networking with other tax enthusiasts.

As this issue reaches your desk, the SOA Spring Meeting held in Hollywood, Fla. from May 24–25, will soon be getting underway. During this meeting, the Taxation Section will be hosting a breakfast. Also, at this Spring Meeting, Taxation Section members Ed Robbins, Peter Winslow and Joseph McKeever will comprise a panel for a session on Principles-Based Reserves with emphasis on the tax implication of adopting a principles based approach for reserving. We hope you are signed up for this spring meeting and these sessions.

The Taxation Section will also sponsor a Product Tax Seminar in Washington, D.C., on September 11-13. The first day of this three-day seminar offers a choice of two optional all day "boot camps". These boot camps will provide an intense introduction to basics of product taxation. One boot camp will focus on Life Insurance Products and the other will focus on Annuities & Long-Term Care Products. Following the optional boot camps on day 1, there will be two days of general sessions covering current product tax issues. Featured products for the general sessions include life insurance, annuities, long-term care, and combination products. As in the past, the IRS will be invited to participate in this seminar. Their participation in the past has been well received, as they have been willing to share their views and perspectives on many of the issues facing our industry. We are really excited about this Product Tax Seminar and feel that it will offer attendees a tremendous amount of product tax information and current updates.

Later in September, the Taxation, Risk Management and Financial Reporting Sections of the SOA will co-sponsor a Capital Efficiency Seminar following the Valuation Actuary Symposium in Scottsdale, Ariz. The dates for the Capital Efficiency Seminar are September 19–20. 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.

Finally, the SOA Annual Meeting will take place on October 16 -18 in Chicago, Ill. We are currently working on taxation topics for sessions at this Annual Meeting. We invite our Taxation Section members to provide input, ideas, and/or a willingness to participate in these sessions. Please contact us if you are interested.

We expect this to be an exciting year for tax seminars and encourage you to look for registration materials for the fall meetings arriving this summer. In addition, registration for all of these seminars can be done on-line through the SOA Web site at *www.soa.org*. Enjoy this current issue of *Taxing Times* and we look forward to seeing you at this year's SOA tax seminars.

Sincerely,
Brian G. King
Editor

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

The Taxation Section, in its second year, is one of the newest and one of the smallest of the SOA sections, but our sights are set on growing! When formed, the Taxation Section set as its mission, in part, to "advance knowledge relating to actuarial tax matters by assisting Section members with the educational, research, networking and other specialized needs that arise with respect to such matters … Our focus will include tax issues related to life insurance companies, insurance and annuity products and employee benefit plans." However, to really achieve this mission, we must increase our membership from outside of the actuarial profession—to tax attorneys, tax accountants and other financial professionals involved in taxes.

Insurance taxation is a subject that encompasses many areas of practice, both actuarial and non-actuarial. The multidiscipline nature of our section is truly unique. Currently, the Taxation Section brings together some of the best insurance tax minds available from the actuarial, accounting and legal fields. This is crucial to our continued success. We simply can't advance knowledge relating to actuarial tax matters without the participation of these other tax professionals. Equally, these other tax professionals gain by working with knowledgeable tax actuaries. They learn about the actuarial tax perspective and they expand the value that they bring to their own tax work. The addition of members from both inside and outside of the SOA gives the Taxation Section a broad-based perspective. Such a multidiscipline perspective strengthens our section and provides an excessively rich tax knowledge reservoir.

To this objective, the Taxation Section has many activities and projects planned that we hope will broaden our exposure outside the SOA. The distribution of this complimentary issue of *Taxing Times* at non-SOA sponsored meetings is just one of our planned 2006 initiatives for reaching out to new corresponding members. This newsletter, packed with insightful and timely articles on insurance taxation will demonstrate one of the benefits of Taxation Section membership. In this issue, the article summarizing the work done by the Maturity Age Task Force of our section shows the excellent results that can be obtained when the many aspects of the insurance tax profession work together. Also in this issue, the multiple articles on principles-based reserves demonstrate the importance of the issues before this section. Getting the right resolution of the federal income tax issues associated with principles-based reserving will require us to collectively bring our expertise to the table.

Thus, I am urging existing members of the Taxation Section—whether you are actuaries, attorneys, accountants or other financial professionals—to get the word out and promote our section. I especially want to urge those non-actuaries who are receiving and enjoying this issue of *Taxing Times*, through other professional organizations, to consider joining the SOA Taxation Section, thereby expanding your value and knowledge as well as our section's value and knowledge. Hopefully the membership application included in this current issue of *Taxing Times* will make joining the section extremely convenient.

The initial successes of the Taxation Section have been outstanding. In year two, we must continue our success. The multidiscipline nature of our section provides us with unique opportunities in the area of insurance taxation. Let's capitalize on them.

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

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principles-based reserve system to help preclude any conflict between that system and the federal income tax rules. Further, one of these items—the mortality assumptions used in the reserve computation—has an important effect beyond the reserve rules of the tax law, reaching into the definition of the premium and cash value limits for life insurance contracts under sections 7702 and 7702A of the Code.[3] In any event, guidance will be needed from the Treasury to assure a smooth, uniform transition from today's "formulaic" reserve system to the principles-based system of tomorrow.

The purpose of this article is twofold. First, it seeks to identify the key issues raised for the federal income tax system by the Draft Model Reg. Second, it offers our views on how these issues can be successfully addressed. These issues and their possible resolutions are considered in three groups. The article first examines four very technical, but nonetheless important, issues involving the section 807(d) rules. It then considers transitional issues raised by the adoption of principles-based reserve rules. And finally, the article considers the effect of such rules on the taxation of life insurance contracts under sections 7702 and 7702A.

II. The Federal Income Tax Rules Governing Life Insurance Reserves

The congressional intent to allow a deduction for no more than "economic" reserves first manifested itself in the 1984 enactment of section 807(d), which sets forth specific rules for computing the deductible amount of life insurance reserves.[4] As originally enacted, section 807(d) defined this deductible amount, with respect to any contract, as the greater of (1) the contract's "net surrender value"—basically, its cash value less any surrender charge – or (2) the contract's reserve specially computed as prescribed in the tax law, which is informally called the "federally prescribed reserve."[5] This federally prescribed reserve was determined in accordance with a method, interest rate, and mortality or morbidity tables specified in the Code. More specifically, to compute the federally prescribed reserve for a life insurance contract, the insurer began with its annual statement reserve and adjusted it as necessary to take into account the tax law's prescribed method and interest and mortality assumptions.[6] In 1987, Congress revised, and generally increased, the interest rate assumed in this computation because it considered the state law-based interest rate previously used to be too conservative (*i.e.*, too low), producing what Congress thought to be redundant federally prescribed reserves.[7]

In addition, according to section 807(d), in no event may the deductible reserve for a contract exceed the amount of the annual statement reserve for that contract.[8] Colloquially, this is called the "annual statement cap." Since the annual statement reserve for a contract is required under uniform state law to equal or exceed the contract's surrender value, it is important to focus on the relationship of the annual statement reserve, or "cap," to the federally prescribed reserve: if the annual statement cap falls below the federally prescribed reserve as a result of the move to principles-based reserves, the cap becomes the deductible amount.

There are four technical requirements in these section 807(d) rules that should be examined in connection with a principles-based reserve system for life insurance contracts like the one being developed by the Academy's working group:

1. the annual statement reserves and the federally prescribed reserves must be determinable on a contract-by-contract, or "seriatim," basis;

2. the federally prescribed reserves must be computed under the "method" specified in the Code;

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[3] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[4] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 211, 98 Stat. 494, 727-29 (1984).

[5] Section 807(d)(1).

[6] *See supra* note 2, at 599.

[7] *See* H.R. Rep. No. 100-391, pt. 2, at 1106 (1987).

[8] Section 807(d)(1).

3. that computation must use the Code's prescribed interest rate; and

4. it also must use the "prevailing commissioners' [mortality] standard tables" as defined in the Code.

Accordingly, when the aggregate stochastic reserves exceed the deterministic reserves for the block, per-contract reserves may be established by allocating the excess amount to specific contracts within the block.

A. Contract-by-Contract Reserves

As just noted, section 807(d) requires two comparisons to be made on a contract-by-contract basis to determine the deductible amount of life insurance reserves: (1) a contract's net surrender value must be compared with its federally prescribed reserve, and (2) the greater of those amounts must be compared with the contract's annual statement reserve, or cap. These requirements imply that each of these amounts can be determined for each life insurance contract.

According to the Draft Model Reg, the amount of principles-based reserves for a particular block of contracts would be the greater of the deterministic reserves and the aggregate stochastic reserves. If the aggregate stochastic reserves represent the greater value and thus determine the amount of the annual statement reserves for the block, the first tax-related issue presented is how the two contract-by-contract comparisons required by section 807(d) can be made in the absence of a per-contract annual statement reserve.

One way to resolve this issue would be to include an appropriate allocation formula in the rules of state law implementing a principles-based reserve system. The deterministic reserves are capable of contract-by-contract computation, while the aggregate stochastic reserves are not; the latter, by definition, are computed in the aggregate for a block of contracts. Accordingly, when the aggregate stochastic reserves exceed the deterministic reserves for the block, per-contract reserves may be established by allocating the excess amount to specific contracts within the block. To accomplish this, the relevant state law rules could include a formula for apportioning (when necessary) the amount of the principles-based reserves to each contract covered in the overall calculation. This type of allocation would seem necessary, quite apart from tax considerations, in order to implement existing state law rules governing life insurance company insolvencies, which require identification of reserves attributable to specific contracts.[9]

If such an allocation formula enabled the determination of a per-contract annual statement reserve in all events, then the two comparisons mandated by section 807(d) could be made regardless of whether the amount of the annual statement reserves was measured by the deterministic or aggregate stochastic computations. Since the net surrender value for a given contract is independently known, it could be compared with the federally prescribed reserve for that contract, as usual. The latter would be computed by adjusting the annual statement reserve for the contract—including the formula-apportioned excess amount when necessary—to take account of the tax law's prescribed method and interest and mortality assumptions to the extent they differed from the basis of the annual statement reserve computation. The greater of the net surrender value or federally prescribed reserve for the contract would then be compared with, and capped by, the per-contract annual statement reserve (again including any allocated excess amount) to determine the deductible amount of the reserve.

There are, of course, no guarantees that the Treasury would find such an allocation approach acceptable in administering section 807(d). The need for allocation of any excess of the aggregate stochastic reserves over the deterministic reserves to contracts within a block for insolvency law purposes provides a substantial, non-tax justification for the allocation. However, it is conceivable that the Treasury, knowing that life insurance reserves were based on today's formulaic approach during the framing of section 807(d) in 1984, could

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[9] *See* Life and Health Insurance Guaranty Association Model Act, § 14.C., *reprinted in* NAIC Model Laws, Regulations and Guidelines, Vol. III, p. 520-30.

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view the advent of principles-based reserves as entailing enough of a change to warrant a re-examination of the section 807(d) rules. Alternatively, the Treasury could view only the deterministic reserve as the logical heir of the formulaic reserve known to Congress two decades ago, at least for purposes of the federally prescribed reserve computation; the annual statement cap would seem a different matter, as it would track the requirements of state law, including the allocation of any aggregate stochastic excess, in determining the amount of the annual statement reserve for any contract. But even Congress recognized that section 807(d) indulged in a bit of fiction when it assumed the existence of contract-by-contract reserves, observing in the legislative history that the computation of reserves on an aggregate basis was much more practical.[10] If the applicable state law rules were to include a suitable apportionment formula, there would be no apparent technical or tax policy reason for the Treasury to propose legislative change on account of the shift to principles-based reserves—or for Congress to spend valuable time addressing a non-problem.

B. The Reserve "Method"

The balance of part II of this article is concerned with whether a principles-based reserve system can co-exist with the determination of the federally prescribed reserve under section 807(d). (The reserve computation "method" and the interest and mortality assumptions dictated by section 807(d) have nothing to do with the determinations of the net surrender value and the annual statement cap used in the statutory comparisons.) As already noted, computation of the federally prescribed reserves involves adjusting annual statement reserves, as necessary, in respect of the method, interest rate, and mortality tables that section 807(d) says must be used in the computation.

Focusing first on the reserve computation method, section 807(d) provides that the method to be used is the Commissioners' Reserve Valuation Method (CRVM) "in the case of a contract covered by the CRVM,"[11] a phrase intended to address most life insurance contracts without specifically saying so. The statute goes on to identify methods applicable to annuity contracts[12] and noncancellable accident and health insurance contracts, all of which, together with life insurance contracts, give rise to "life insurance reserves" within the meaning of the Code.[13] In the case of any other contract, according to section 807(d), the method to be used is "the reserve method prescribed by the National Association of Insurance Commissioners which covers such contract (as of the date of issuance)," and if there is no NAIC-prescribed method with respect to a contract, and only in that case, the method to be used is whichever of the foregoing methods "is most appropriate" for the contract involved.[14]

It should be clear to anyone reading the "method" portion of section 807(d) that Congress was endeavoring to defer to the NAIC's determination of the appropriate reserve method for a contract. This was necessary because the calculation of the federally prescribed reserve required the specification of something beyond the interest and mortality assumptions that were rather easily defined. The specification of the reserve method was intended as the instruction of "everything else" that needed to be known to enable the new, tax law-specific reserve to be calculated. While the reference to the CRVM in the method rule had a particular purpose in 1984—to require the federally prescribed reserve to be computed on a 1-year preliminary term basis—in all other respects the rule was purely residual in nature: if one method does not apply, default to the next one, and so on until a method can be found that does apply, always deferring to the NAIC.

The Draft Model Reg describes the principles-based reserve system set forth in it as the CRVM for life insurance contracts. Therefore, if the Draft Model Reg were adopted in its present form by the NAIC, under section 807(d), the federally prescribed reserve would be required to be calculated using it. Further, if the Treasury were to consider the Draft Model Reg's system to be sufficiently distinguishable from the CRVM known to Congress in 1984 (*e.g.*, see the following discussion) that it should not be deemed the CRVM, section 807(d) still would mandate the use of that system in computing the

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10 *See supra* note 2, at 599.

11 Section 807(d)(3)(A)(i).

12 Section 807(d)(3)(A)(ii).

13 Section 807(d)(3)(A)(iii).

14 Section 807(d)(3)(A)(iv).

federally prescribed reserve, since it would be the NAIC-prescribed method. Thus, there is no technical reason why the Treasury should seek to upset the NAIC's prescription of a principles-based reserve system as the CRVM.

From a tax policy perspective, a noteworthy change to the method that the Academy's working group is proposing is the use of a gross premium valuation method.

From a tax policy perspective, a noteworthy change to the method that the Academy's working group is proposing is the use of a gross premium valuation method. Specifically, the reserve (whether deterministic or aggregate stochastic) is computed prospectively as the present value of future benefits less the present value of future premiums. Importantly, for this purpose the future premiums are not net premiums (determined based on interest and mortality assumptions) as in the past, but rather equal to the gross premiums for the contracts being valued less related expenses.

It is unclear whether the Treasury would view the change to a gross premium valuation method to be a problem, in and of itself, in applying the section 807(d) rules. The Internal Revenue Service (IRS) has interpreted the predecessor to section 816(b), which generally defines life insurance reserves for purposes of taxing life insurance companies, as prohibiting the use of gross premiums in calculating life insurance reserves.[15] It is highly doubtful that the Treasury would consider that position as binding in the interpretation of section 807(d), especially given that the CRVM incorporates the use of the gross premiums by requiring the use of the lower of the gross premium and the net premium for valuing reserves.[16] More importantly from the standpoint of tax policy, if the inclusion of an expense element in reserves will have the effect of reducing the amount of the reserves *versus* what it would be without that element, as some actuaries believe to be the case, this would have the effect (all else being equal) of decreasing the amount of reserves that a life insurer could deduct for tax purposes. In other words, if the expense element uniformly (or virtually always) turns out to be negative, moving to a gross premium valuation method would result in reduced reserve deductions—a result that seemingly would not be of concern to the Treasury. Overturning the use of the NAIC-prescribed method as the section 807(d) method would require congressional action, and there would seem to be no reason, and no case, for the Treasury to seek legislative change in such circumstances.

On the other hand, the Treasury could resist acceptance of the methodology of principles-based reserves as the section 807(d) reserve method out of concern that it would increase the difficulty of auditing the federally prescribed reserves. It is true that auditing any set of numbers is simpler when the auditor merely can follow a uniform formula. However, this does not mean that federally prescribed reserves computed using a principles-based methodology, together with the prescribed interest and mortality assumptions discussed here, cannot be audited. Complex calculations that make use of historical experience and judgments exist in other areas with which the federal tax law concerns itself, and all such calculations are subject to review by IRS auditors.[17] Since life insurers, like other taxpayers, are required to retain records that adequately document how they arrived at their taxable income calculation, the IRS should be able to replicate the computation of the federally prescribed reserves by reviewing those records during an audit.

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[15] Rev. Rul. 77-451, 1977-2 C.B. 224.

[16] *See supra* note 2, at 598 (stating that a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the section 807(d) reserve computation, and for example claim treatment as unearned premiums under section 807(c)(2), in order to use statutory reserve amounts for tax purposes).

[17] For example, the calculation of the section 415 limits on benefits and contributions under tax-qualified deferred compensation plans involves the use of many assumptions and constraints on assumptions. Also, property and casualty insurance companies can use their own historical claims payment patterns rather than published discount loss factors in computing discounted unpaid losses. See Rev. Proc. 92-76, 1992-2 C.B. 453.

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It is, of course, possible that the Treasury could ask Congress to revise section 807(d) following adoption of principles-based reserves on the ground that the method underlying such reserves differs from what Congress contemplated when it enacted section 807(d). However, the statute itself shows that Congress did not concern itself with the specifics of the CRVM or other applicable reserve method at that time; it was content with whatever method the NAIC prescribed, as evidenced by the rule that any reserve method prescribed by the NAIC that applies to a particular type of contract is the method to be used for tax purposes. Congress's concern, rather, was with establishing a "federally prescribed" limit on the deductible amount of life insurance reserves that comported with economic reality and avoided redundancy in the deductible reserve amount. This seems entirely compatible, again, with the ultimate goal of the Academy's working group.

C. The Interest Rate

In determining the federally prescribed reserve for a life insurance contract, section 807(d) also requires the use of an interest rate, determined at the time the contract is issued, equal to the greater of (1) the "applicable Federal interest rate" or (2) the "prevailing State assumed interest rate."[18] The former is an annual rate determined anew by the IRS each year, based on a five-year rolling average of the applicable Federal mid-term rates,[19] while the latter is the highest assumed interest rate permitted to be used in computing reserves for the contract under the insurance laws of at least 26 states (disregarding the effect of nonforfeiture laws on valuation interest rates).[20]

The Draft Model Reg currently contemplates that a standard, long-term yield curve based on predicted future Treasury bill rates will be prescribed by the NAIC for use in determining the annual statement reserves, with the recognition that the rates may change over the life of a given contract. The Draft Model Reg also suggests that insurers with sufficient credible investment experience could use, in lieu of the actual rates falling on the aforementioned long-term yield curve, the actual rates that each of their investments is designed to earn. It contemplates that a life insurance company's reserve calculation could take into account dynamic, short-term rates derived from the asset base of the company and its own investment experience.

It is unclear how this proposal could be construed as containing a "prevailing State assumed interest rate." Conceivably, the Treasury could conclude that a prevailing State assumed interest rate within the meaning of section 807(d) no longer exists under a principles-based reserve system. However, it does not automatically follow that Congress would need to re-examine the section 807(d) rules. Quite to the contrary, section 807(d) could readily be interpreted to provide that in the absence of a prevailing State assumed interest rate, the computation of federally prescribed reserves must use the "applicable Federal interest rate" exclusively. Indeed, Congress and the Treasury may well be satisfied with such a result. The relevant applicable Federal interest rate will continue to exist, and in fact it was the rate that Congress added to the tax reserve calculations in 1987 because, as noted previously, it viewed the prevailing State assumed interest rate as being too conservative and thus as producing redundant federally prescribed reserves. More often than not in recent years, the prevailing State assumed interest rate applicable to life insurance contracts was lower than the applicable Federal interest rate under section 807(d). Further, to the extent that even higher interest assumptions (and/or more liberal mortality assumptions) are utilized in determining principles-based reserves, the tax law will give recognition to such assumptions via the annual statement cap. In any event, it appears that any issue involving the interest assumption under section 807(d) should be capable of a satisfactory resolution without legislation.

D. Mortality Tables

As a final matter where the federally prescribed reserves are concerned, the computation of such reserves is required by section 807(d) to use the "prevailing commissioners' standard [mortality] tables." Section 807(d) defines these tables, with respect to any contract, as the most recent commissioners' standard tables prescribed by the NAIC and permitted to be used in computing

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[18] Section 807(d)(2)(B).

[19] Section 807(d)(4)(A)(i), referencing the rate under section 846(c)(2).

[20] Section 807(d)(4)(B).

reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued.[21] Currently, the prevailing commissioners' standard tables for life insurance contracts are the 2001 CSO tables.[22] Section 807(d) further provides that if no standard mortality table applies to a given contract, the Treasury Department can promulgate one for use in determining the contract's federally prescribed reserve.[23]

The Academy working group's draft actuarial guideline setting forth valuation assumptions contemplates that standard mortality tables would be prescribed by the NAIC for use in determining the annual statement reserves for life insurance contracts under a principles-based reserve system. Under a principles-based reserve system like the one being developed, the standard mortality experience reflected in the prescribed tables could be adjusted by a company in determining its annual statement reserves if the company possessed sufficient experience to warrant such an adjustment.

For section 807(d) to work in its current form, avoiding disruption in the tax treatment of life insurers, it is important that standard mortality tables continue to be prescribed by the NAIC and approved by the states for use in determining annual statement reserves for life insurance contracts, along the lines indicated in the Academy's proposal. Further, as discussed here, it is important that the tables so prescribed are the ones also used in determining the minimum nonforfeiture values for life insurance contracts under state law.

The Treasury might disagree that the tables so prescribed meet the definition of prevailing commissioners' standard tables under section 807(d), perhaps on a theory that the annual statement reserve computations would not be wholly dependent upon the tables. Such a determination would necessitate either the promulgation of mortality tables by the Treasury or reference

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of the matter to Congress. However, if the NAIC continues to approve standard mortality tables that could be employed to compute federally prescribed reserves for life insurance contracts, there should be little incentive for the Treasury to go to such trouble. Again, to the extent that more liberal mortality assumptions (perhaps in combination with higher interest assumptions) were to be employed in any company's principles-based reserve computations, the tax reserve rules would recognize the use of such assumptions via the annual statement cap.

Finally in respect to mortality tables, one other tax provision should be discussed. As stated previously, the life insurance reserves that are subjected to the deduction limits imposed by section 807(d) are themselves defined in section 816(b). Section 816(b), in turn, defines such reserves (in relevant part) as amounts "computed or estimated on the basis of recognized mortality or morbidity tables." This rule has a lengthy history, but what constitutes "recognized" tables has been liberally construed by the IRS in recent times.[24] Reserves based, in whole or part, on NAIC-prescribed standard mortality tables should meet the section 816(b) definition. Indeed, were the Treasury to disagree, it would effectively be authorizing a wholesale escape of reserves from the limits of section 807(d) and

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[21] Section 807(d)(5)(A).

[22] *See* Notice 2004-61, 2004-41 I.R.B. 596. Under the transition rule provided in section 807(d)(5)(B), the previously prevailing 1980 CSO tables may continue to be used in determining the federally prescribed reserves for contracts issued through the end of 2007.

[23] Section 807(d)(5)(C).

[24] This trend is most noticeable in Rev. Rul. 89-43, 1989-1 C.B. 213, holding that certain reserves for long-term care insurance contracts are life insurance reserves. There are no standard mortality or morbidity tables for long-term care insurance, so that, as the IRS's ruling recognizes, the reserves are reflective of an insurer's own experience.

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the reclassification of many life insurers into tax status as property and casualty insurance companies, entitling them to much more favorable proration and life-nonlife consolidation treatment than is currently afforded them. This is a road that presumably would not be taken.

III. The Effect of Principles-Based Reserve Rules on Pre-Existing Business

One issue not resolved in the Draft Model Reg is the prospective *versus* retroactive effect of a new principles-based reserve system, *i.e.*, whether the new rules not only would govern the valuation of contracts issued after a certain future date, but also would require a restatement of the reserves for all previously issued contracts then in force. The pros and cons of applying one treatment rather than the other will be debated within the life insurance industry and the NAIC for some time to come, as the complexity and cost of maintaining two different valuation systems (*i.e.*, prospective application of the new rules) are weighed against the complexity and cost of re-valuing the in-force book of business (retroactive application).

From a federal income tax standpoint, the applicable rules and related considerations may be stated simply enough. If the new valuation standard is accorded prospective effect, the federally prescribed reserves and (as relevant to the annual statement cap) the annual statement reserves for the pre-existing in-force business will continue on as before. Further, both types of reserves for newly issued contracts would need to adapt to the use of the new rules, as discussed above.

If, to the contrary, the new standard were made retroactively effective, there would be a sharp divergence in the computation of one type of reserve *versus* the other in respect of the in-force business on the effective date of the new rules. As noted in the description of the section 807(d) rules in part II, the computation of the federally prescribed reserve for a given contract makes use of the method and the interest and mortality assumptions applicable as of the contract's date of issuance. Hence, if the method, interest rate, and/or mortality tables change with respect to that contract after it is issued, the change is simply irrelevant in the determination of the federally prescribed reserve. On the other hand, where the annual statement reserve is concerned—as relevant to the annual statement cap—the retroactive effect given to the new valuation standard would require a restatement of that reserve as of the new standard's effective date. The restated reserve could, of course, be higher or lower than, or the same as, what the pre-existing reserve would have been had the rules not changed. If the restatement were to result in a decrease in the amount of the annual statement reserve, and if that amount were less than the federally prescribed reserve, the annual statement cap (or perhaps a cap in a still lower amount) would take effect, reducing a life insurer's reserve deduction. And if the restatement were to produce the opposite result, it is possible that the reserve deduction would increase over the deductible amount under the pre-change rules.

In either case, the retroactivity of the new standard would likely attract increased scrutiny by the Treasury, as the immediate impact on federal tax receipts from the industry resulting from adoption of the new rules could be far more pronounced. Such retroactivity also could raise technical questions, *e.g.*, as to the applicability of the 10-year spread rule of section 807(f) to the annual statement cap, along with related tax policy questions. Further, such retroactivity could raise additional questions as to how to allocate any excess of the stochastic reserve over the deterministic reserve to contracts issued prior to the adoption of the new standard.

IV. The Product Tax Rules and Principles-Based Reserves

As noted in part II.D, section 807(d) defines the "prevailing commissioners' standard [mortality] tables" to be used in determining the federally prescribed reserves for life insurance contracts. Further, if no such tables exist with respect to a given contract, section 807(d) leaves it to the Treasury to define the mortality assumptions to be used in determining the federally prescribed reserve for that contract. These rules also are utilized outside of section 807(d) in a manner important to life insurers: they are incorporated by reference, albeit with some significant modifications, into the calculation of the life insurance premium and cash value limits under the definitions of "life insurance contract" and "modified endowment contract" in sections 7702 and 7702A, respectively.

More specifically, section 7702(c)(3)(B)(i) requires the "guideline premiums" for a contract under section 7702(c) to be based on "reasonable" mortality charges that "do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5))." This "reasonable mortality" rule is incorporated as well into the computation of the "net single premiums" under section 7702(b) (relating to the "cash value accumulation test") and the determination

of the so-called 7-pay premiums under section 7702A. For all of these purposes, section 7702(c)(3)(B)(i) further authorizes the Treasury to issue regulations requiring the use of mortality assumptions that diverge from the NAIC-prescribed tables. To date, however, guidance from the Treasury has accepted the use of the NAIC-prescribed tables in all of the section 7702 and 7702A computations. In general, under the most recent Treasury guidance, the 1980 CSO tables may be used until the beginning of 2009, and the 2001 CSO tables may be used thereafter (absent promulgation of new NAIC-prescribed tables), in determining the guideline premium, net single premium, and 7-pay premium limits.[25]

Not unlike the case with section 807(d), in order for sections 7702 and 7702A to work in their current form, it is important that standard mortality tables continue to be prescribed by the NAIC and approved by the states for use in determining annual statement reserves for life insurance contracts, along the lines indicated in the Academy working group's proposal. This would avoid potential disruption in the tax treatment of life insurance products stemming from the absence of such prescription and approval and, in their stead, the Treasury's promulgation of its own set of "reasonable mortality" assumptions to be used in the premium and cash value limits for life insurance contracts. Moreover, it is important that the NAIC-prescribed valuation tables are the ones also used in determining the minimum nonforfeiture values for life insurance contracts under applicable state law.

If the permitted valuation and nonforfeiture assumptions were to diverge, such that the mortality assumptions applicable under section 807(d) became more liberal than the assumptions underlying the minimum nonforfeiture values, the federal "ceiling" on cash values under section 7702(b)'s cash value accumulation test could well fall below the state law "floor" for those values, rendering impossible the compliance of traditional, whole life contracts issued in reliance on that test. In that event, ironically, the industry would be placed in the position of imploring the Treasury to exercise its regulatory authority under section 7702(c)(3)(B)(i) to prescribe mortality assumptions (*i.e.*, those utilized in the nonforfeiture law) in order for companies to be able to issue traditional products. But if, on the other hand, the existing situation were to be preserved—the NAIC continues to prescribe standard mortality tables for valuation purposes and these tables also are used in determining minimum nonforfeiture values—it becomes difficult for the Treasury to diverge from those tables in implementing the "reasonable mortality" rules, not least because doing so would disadvantage the traditional product forms.

V. Summary and Conclusion

The inherent features of the principles-based reserve system for life insurance contracts now being developed by the Academy's Life Reserve Working Group are not inconsistent with the current federal income tax rules governing the deductibility of life insurance reserves. As previously described, those rules are quite flexible and resilient. However, a smooth transition to the adoption of a principles-based reserve system would be facilitated by including three specific features in any system ultimately adopted by the NAIC and the states: (1) a formula for apportioning the amount of the principles-based reserves to each contract covered in the overall reserve calculation, (2) adoption of the new system by the NAIC as the CRVM with respect to the life insurance contracts it covers, and (3) continued use of standard mortality tables that are prescribed by the NAIC and approved by the states in determining the reserves for the contracts covered by the new system.

Further, for the Code's product tax rules (sections 7702 and 7702A) to continue to function properly, the same standard mortality tables used in computing the principles-based reserves for life insurance contracts also should apply in determining the minimum nonforfeiture values for those contracts. In any event, guidance will be needed from the Treasury to assure a smooth, uniform transition from the current reserve system to a principles-based system. For its part in shepherding such a transition, the Treasury can take comfort from the fact the desire of Congress in limiting the deductible amount of life insurance reserves to "economic" reserves is well aligned with the purpose underlying the Academy working group's development of principles-based reserves. ◂

Joseph F. McKeever, III, is a partner with the Washington, D.C. law firm of Davis & Harman LLP and he may be reached at *jfmckeever@davis-harman.com.*

John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and he may be reached at *jtadney@davis-harman.com.*

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

[25] See Notice 2004-61, note 22, *supra*. This Notice was discussed in detail beginning on page 1 of the May 2005 issue of *Taxing Times*.

Tax Implications of Applying Principles-Based Reserves Retroactively

by Kory J. Olsen

As many are aware, there is a growing movement for statutory reserves to be based on "principles" rather than the current formulaic approach. These principles-based reserves (PBR) are generally comprised of a stochastic reserve with a deterministic floor.

Variable annuities were the first product for which PBR was developed. After years of trying to reserve for variable annuity guarantees according to a fixed formula CARVM approach, a stochastic approach was developed, based on the concept in RBC C-3 Phase 2. Since the emergence of PBR for variable annuities, it has spread to life insurance products and more recently to all annuity products.

An item under current discussion is whether the application of PBR for life insurance should be retroactive, either fully or partially. Statutory retroactivity creates many concerns among tax practitioners. To begin, we need to have a high-level understanding of the draft reserve requirements[1] and key issues in the tax law.

Life Reserves

The draft reserving requirements for life insurance products incorporates a gross-premium valuation that includes an aggregate stochastic (modeled) reserve with a deterministic (seriatim) reserve floor. The stochastic reserve would include at least stochastic interest rates, whereas the deterministic reserve would have a single interest rate scenario. Both calculations would start with the current U.S. Treasury yield curve.

All other assumptions are set based upon the concept of Prudent Best Estimate (PBE). Prudent Best Estimate is defined as "the deterministic valuation assumptions used for projections that are developed by applying a margin for estimation error and adverse deviation to the best-estimate assumption." The PBE concept calls for reevaluating your assumptions at each valuation date.

In essence, the assumptions for PBR are not locked-in at issue, and can change with each valuation. This is a change from the current statutory reserving requirements. The current requirements have the mortality table and interest rate set at issue and are generally not changed for the life of the policy.

Federally Prescribed Reserves

IRC Section 807(d)(3) stipulates that the federally prescribed reserves (FPR) for life insurance contracts would generally be calculated according to CRVM. It further defines CRVM as "the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect *on the date of the issuance* of the contract." Therefore, once the CRVM reserving methodology is determined for a policy at issue, it will not change.

The interest rate and mortality table used for the FPR is set at issue and locked-in. Any change to these assumptions generally results in an IRC Section 807(f) change-in-basis and results in a 10-year spread of the reserve difference.

Retroactivity Impact

Until now, tax and statutory methodology and assumptions have been reasonably "parallel," with the result that the FPR is generally somewhat lower than the statutory reserve in almost all cases. Retroactivity would cause a sharp break in this relationship on the entire existing in force block at the moment that retroactivity would take place.

If PBR is made retroactive for statutory reserves, this will not impact the FPR assumptions or methodology, which are established at issue. It most likely will impact the final tax reserve, which is the greater of the FPR and the

[1] The draft PBR reserving requirements for life products are included in the following NAIC exposure documents: Principles-Based Reserves for Life Products Model Regulation; Actuarial Guideline PBR, Determining Valuation Assumptions for Principles-Based Life Insurance Products; Actuarial Guideline DIS, Documentation and Disclosure Requirements when Determining Reserves Based on the Principles-Based Life Reserves Model Regulation; Actuarial Guideline MAR, Requirements for Establishing Margins for Prudent Best Estimate Valuation Assumptions when Determining Reserves Based on the Principles-Based Life Reserves Model Regulation.

net surrender value, but in no case greater than the statutory reserve. This "statutory cap" on the FPR will fluctuate along with the statutory reserve changes based on PBR methodology. Such a change in the statutory cap may be subject to a 10-year spread.

The fluctuations will result from the mismatch in both methodology and assumptions between the FPR and the statutory reserve. These fluctuations will have a "whipsaw" effect on the final tax reserve. The "whipsaw" effect is created because an increase in statutory reserves from existing methodology usually will not increase the final tax reserve, whereas a decrease from existing methodology usually will decrease the final tax reserve.

The three examples to the right help illustrate the "whipsaw" effect that can be created. Example 1 shows a typical relationship for the tax reserves of different policies under the current reserving structure. The FPR is usually less than the statutory reserve; however the FPR for some policies may be greater than the statutory reserve. Ultimately the FPR is capped by the statutory reserve.

In Example 2, the statutory reserve after application of PBR is less than the current statutory reserve. In this case, the FPR is drastically capped by the new lower statutory reserve. This would create a lower final tax reserve even though the policy and the FPR have not changed.

In Example 3, the statutory reserve is higher after the application of PBR. Note that the tax reserve increases for contract Y, as it was previously capped by the statutory reserve. Even with the increase in the tax reserve for contract Y, the tax reserves are considerably lower than the statutory reserves.

Example 2 is expected to be the most common. Thus, in most cases the final tax reserve will only decrease. If the tax reserve does increase, the increase will most likely be small compared with the change in the total statutory reserve.

These examples illustrate that, given the non-parallel nature of PBR statutory methodology and assumptions versus tax methodology and assumptions on the entire in-force block, retroactivity can potentially result in severe statutory capping on some blocks of business and severe overhangs (statutory reserves in excess of FPR values) in others.

Conclusion

There has been very limited modeling done so far of the new reserve proposals—let alone the effect of retroactivity. Some statutory modeling has been performed by an American Academy of Actuaries group involved, but no tax basis modeling has been completed yet. Although a tax group has been looking at PBR, the PBR movement appears to be forging ahead with little attention given by the actuarial community as a whole to a possibly significant post-tax impact. The testing that has been done to date has shown that small changes in assumptions and margins can have a dramatic impact on the reserve. Moreover, as financial reporting actuaries know, small percentage changes in tax reserves can have a significant effect on taxable income. With the changing assumptions and different methodology between statutory reserves and the FPR, there is only a downside for tax reserves if the application of PBR for life products is made retroactive. The ultimate impact could potentially be a major financial loss to the insurance industry.

Example 1
Prior to PBR

Policy Number	Statutory Reserve	FPR	Final Tax Reserve
X	100	95	95
Y	95	98	95
Total	195	193	190

Example 2
After PBR with a lower statutory reserve

Policy Number	Statutory Reserve	FPR	Final Tax Reserve
X	85	95	85
Y	80	98	80
Total	165	193	165

Example 3
After PBR with a higher statutory reserve

Policy Number	Statutory Reserve	FPR	Final Tax Reserve
X	110	95	95
Y	105	98	98
Total	215	193	193

Kory J. Olsen, FSA, MAAA, CFA, is an actuary with Allstate Life Insurance Company and may be reached at *kolsen1@allstate.com*.

T3: *Taxing Times* Tidbits

Actuaries Weigh in on IRS Circular 230

by Peter H. Winslow and Susan J. Hotine

In the September 2005 issue of *Taxing Times*, we raised a question as to whether § 10.35 of IRS Circular 230, issued June 20, 2005, could apply to in-house or consulting actuaries who prepare written tax analysis (e.g., under I.R.C. § 7702), but do not practice before the IRS. It appears that, in drafting that section of the Circular, the IRS intended that its provisions would apply to enrolled actuaries who prepare actuarial reports (Forms 5500, Schedule B) for qualified plans. Under Circular 230, any written tax advice that is expected to be relied upon to avoid penalties, to be used in marketing or is another type of "covered opinion," must consider all the relevant facts and federal tax issues.

By letter dated October 28, 2005, the American Academy of Actuaries submitted comments on § 10.35 of Circular 230, which pointed out serious flaws in the IRS requirements as they relate to valuation reports prepared by pension actuaries.

Confidentiality—Under the Circular, a "covered opinion" includes written tax advice with respect to any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax if the advice is subject to conditions of confidentiality. The Academy pointed out that actuarial reports usually require confidentiality to prevent inappropriate third-party reliance and that the rules for "covered opinions" serve no purpose in this context.

Incomplete Data—The Academy took issue with the Circular's prohibition against basing an opinion on incomplete data pointing out that actuarial valuations are performed routinely despite missing data. The Academy argued that actuarial standards of practice should govern on whether or not the data is sufficient to render an opinion.

Qualified Plan Exception—Circular 230 provides that written advice, which concerns the qualification of a qualified plan, is not a covered opinion subject to the IRS' stringent requirements unless the advice relates to a plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax. The Academy had many comments on this provision. Primarily, it sought confirmation that creation or maintenance of a qualified plan should never be considered a transaction, which has the principal purpose of tax avoidance or evasion. It also sought clarification that advice routinely provided by pension actuaries will be within the scope of this exception, even if the advice does not technically relate to a plan's qualification (e.g., advice relating to minimum funding or distribution requirements).

Best Practices—Circular 230 provides guidance on "best practices" of tax practice. Although this guidance is labeled merely "aspirational," the Academy noted that failure to follow the guidance could be used by plaintiffs' attorneys in civil court actions to impeach the work of actuaries. To minimize this risk, the Academy requested more specificity in this section of the Circular so that it could not be used inappropriately in private litigation.

At their core, the comments of the Academy reflect a desire for pension actuaries to be excluded from the requirements of Circular 230 when they are acting in their capacity as actuaries. After all, actuaries do not practice tax law and, although they frequently are required to interpret relevant provisions of the Internal Revenue Code and practice before the IRS, they do not provide legal tax advice. So far, the IRS has expressed a reluctance to revisit § 10.35 of Circular 230 to narrow its scope in the many areas where it has been criticized as overreaching. It remains to be seen whether the Academy's comments will be received favorably and acted upon.

Reformation of Insurance Contracts

by Peter H. Winslow and Stephen P. Dicke

A recent private letter ruling (PLR) issued by the IRS National Office reminds us that adverse tax consequences that may flow from the literal language of an insurance policy sometimes can be avoided if that literal language is contrary to the actual agreement of the insurer and the policy owner. In PLR 200603002 (Oct. 24, 2005), a husband and wife each owned life insurance policies, which named the owner as a beneficiary. The husband and wife created a revocable trust and executed a document entitled "transfer by gift" signed by the husband

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.*

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

Stephen P. Dicke is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *sdicke@scribnerhall.com.*

and wife and their four children that set forth the terms of gifts that the husband and wife intended to make to the trust on behalf of the children. Under the terms of the transfer by gift, the husband and wife were to exchange their policies for a single last-to-die policy that would be transferred to the trust, with the trust designated as the new owner. Contrary to instructions, the insurance agent made a mistake and caused the new policy to list the husband and wife as joint owners. When the husband and wife discovered the mistake, they moved to reform the insurance policy, and sought the PLR from the IRS that the policy reformation would not result in a transfer for gift and estate tax purposes.

The IRS noted that, although the general rule is that the terms of the policy govern, there is an exception to the rule where the insurance contract itself does not reflect the intentions of the parties. A leading tax case that followed this principle is *Estate of Fuchs v. Commissioner*, 47 T.C. 199 (1966), acq., 1967-1 C.B. 2, where the court held that the value of life insurance policies was not includable in a decedent's estate, even though the policy terms gave the decedent incidents of ownership, because the insurance agent had been instructed that the beneficiaries were to be designated as sole owners. In applying the principle of the *Estate of Fuchs* case to the facts in PLR 200603002, the IRS concluded that the trust should be considered to be the owner of the joint and survivor policy from its inception, despite the insurance agent's mistake. Based on this conclusion, the IRS ruled that the reformation would not result in a gift or estate tax transfer in the year of the reformation, but was a gift at the time of the original transfer to the trust.

In reaching its conclusion, the IRS stated: "We cannot see any distinction between the situation when an agent gratuitously adds an unwanted clause in an insurance policy and the situation presented herein when the agent fails to include a desired provision or removes an undesired one." This observation presents a valuable reminder that, in appropriate circumstances, reformation of a contract may be appropriate where, through inadvertence and contrary to the mutual intent of the parties, a life insurance or annuity contract is missing a rider or other provision that was intended to ensure the contract's tax qualification. For example, suppose a life insurance company markets its annuity contracts as tax-favored investments, but forgets to attach a distribution-at-death rider that was designed to ensure their tax qualification as annuity contracts under I.R.C. § 72(s). Assume that the insurer administers its annuity contracts, including the contracts with the missing riders, in compliance with I.R.C. § 72(s). In these circumstances, the parties would have a strong argument that the contract reformation principle relied upon by the IRS in PLR 200603002 applies here as well, so that the contracts can be reformed to reflect the mutual intent of the parties to comply with I.R.C. § 72(s) from the original issue date.

Resisted Claims Are Deductible by Life Insurance Companies

by Peter H. Winslow and Lori J. Brown

It is well settled that an insurance company, which is not taxed as a life insurance company for federal income tax purposes, is entitled to deduct resisted claims as part of its reserves for losses incurred. Rev. Rul. 70-643, 1970-2 C.B. 141. Resisted claims are those losses reported to an insurance company for which the company either denies liability or contests the amount of its liability for the loss. Resisted claims on casualty and accident and health policies are deductible subject to discounting under I.R.C. § 846. Resisted claims on life insurance policies, as a practical matter, are deductible in the full amount reported on the annual statement by a non-life insurance company, even though it may be unlikely that the company will pay all of the claims. This is because the reasonableness of the losses incurred deduction is tested on an aggregate basis and the IRS is not authorized to disallow a deduction for the portion of resisted claims the company does not expect to pay without first establishing that the aggregate deduction for all losses incurred is outside a reasonable range. Rev. Proc. 75-56, 1975-2 C.B. 596.

For life insurance companies, the treatment of resisted claims is more complicated. For casualty-type resisted claims, including claims on accident and health insurance contracts, the same general rules applicable to non-life companies apply to life companies, i.e., resisted claims are included in full in losses incurred and are deductible on a discounted basis under § 846. Rev. Rul. 72-432, 1972-2 C. B. 400. However, controversies frequently arise on audit with respect to resisted death claims arising under life insurance contracts.

First, IRS agents often attempt to disallow the deduction for resisted claims on the basis that: (i) death claims are not includable in the reserves for unpaid losses under I.R.C. § 807(c)(2) and (ii) are deductible on an accrual basis under I.R.C. § 811(a), which places life companies on an accrual method of accounting for non-reserve items. See Rev. Rul. 72-115, 1972-1 C.B. 200. Because the claims are resisted, they generally do not meet the requirements for a deduction under the accrual method. It is doubtful whether this argument of IRS agents has any continuing validity after the Tax Reform Act of 1986. The legislative history strongly suggests that Congress intended life and non-life companies to be treated alike with respect to unpaid losses, including resisted claims. S. Rep. No. 313, 99th Cong., 2d Sess. 500-01 (1986). In addition, Congress added the last sentence of I.R.C. § 807(c), which, by negative inference, suggests that unpaid death claims on life insurance contracts are included in unpaid losses under

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

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I.R.C. § 807(c)(2) on an undiscounted basis. Perhaps in recognition of this, the Internal Revenue Manual at 4.42.3.3.1(8) now provides that resisted claims "due to suicide or misrepresentation in the application" are allowable if they are supported by "an allocation based on historical development."

Second, IRS agents may argue that a deduction for the full amount of resisted claims is not allowable. Unlike non-life companies, which typically can deduct the full amount of resisted claims (after taking into account any applicable discounting) because they have a large amount of claims in other lines and the aggregate deduction for unpaid losses is considered reasonable, life companies usually have a small number of total unpaid claims at year-end. This increases the likelihood that the IRS will be able to challenge the reserve for resisted claims on the basis that it is not reasonable. That is, according to the IRS, it is unreasonable to assume that 100 percent of resisted claims will be paid, but it is reasonable for a life insurance company to deduct resisted claims on life policies on the basis of historical development. However, because of the small number of claims by the life company, in many cases, the historical development of prior resisted claims may not be a reliable measure of the amount the life company actually expects to pay on the current year claims. Nevertheless, establishing a deduction for resisted claims based on an historical development percentage is supported by the Internal Revenue Manual and may be preferable to a deduction based on a case-by-case analysis of the settlement value of each resisted claim.

FAS 109 Interpretation Likely Effective in 2007

by Brian G. King

On July 14, 2005, the Financial Accounting Standards Board ("FASB" or "the Board") issued an exposure draft on proposed Interpretation, Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109 (FAS 109). (See article outlining the details of the proposed Interpretation in the December 2005 issue of *Taxing Times*). FAS 109 is designed to clarify when tax benefits may properly be recognized and to reduce the diversity in accounting for taxes.

In light of the numerous comment letters solicited on the proposed interpretation, the Board is expected to make several modifications. The final interpretation, reflecting these changes, is expected during the first half of 2006. As originally drafted under the proposed interpretation, the recognition of a tax benefit would occur when it is "probable" that the position would be sustained on audit. The Board is expected to change the initial recognition standard from probable to "more likely than not." The probable standard was meant to have the same meaning that it has in FASB Statement No. 5 (FAS 5), Accounting for Contingencies. The FAS 5 definition of probable (i.e., that which is likely to occur—determined to be about 70 percent) represents a level of assurance that is substantially higher than more likely than not (i.e., a level of likelihood greater than 50 percent).

It is also expected that the final Interpretation will reflect a one-year delay from the effective date in the proposed interpretation, making the standard effective in 2007 for most companies. The effective date in the proposed Interpretation was for fiscal years ending after December 15, 2005.

Taxing Times will continue to comment on further updates or modifications to interpretations on FAS 109, if and as, they develop.

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

AFR at a Record Low

by Bruce Schobel

On November 18, 2005, the IRS released its table of applicable federal interest rates (AFRs) for December 2005. The mid-term annual interest rate for December 2005 was 4.52 percent. This rate was the last of the 60 monthly figures needed to determine the 2006 AFR for purposes of IRC section 807. IRC section 807 prescribes the assumptions and methodology for computing Federally prescribed reserves. The result of this rolling average calculation was a rate of 3.98 percent. This 2006 AFR for section 807 is the lowest that this rate has ever been, and is well below the comparable 2005 rate of 4.44 percent (the previous recorded low).

For the second consecutive year, the section 807 AFR is lower than the prevailing state assumed rate (PSAR) for all types of contracts. The PSAR for long-term life insurance contracts issued in 2006 is only slightly higher at 4.0 percent. When the PSAR is higher than the AFR, section 807 states that the PSAR is the rate that must be used to compute Federally prescribed reserves. Thus, tax reserves and statutory reserves are essentially equal. This is good news with respect to surplus. When the AFR exceeds the PSAR, as was the case for more than 15

Bruce Schobel, FSA, MAAA, is a vice president and actuary with New York Life Insurance Company. He may be reached at *bdschobel@aol.com.*

years, then tax reserves are less than statutory reserves, and Federal income taxes must be paid on the difference.

Because the section 807 AFR is a 60-month moving average, it should remain low—even below 4 percent—for a few more years, even if current interest rates rise slightly. The PSARs are based on a 36-month or 12-month moving average, depending on the product. Thus, these rates react more quickly to changes in interest rates. If interest rates do rise, as many analysts expect, then the PSAR is likely to continue to exceed the AFR for quite a while.

The Effect of E-filing Requirements on the Insurance Industry

by Steven M. Greene, Thomas E. Barber and Gregory L. Stephenson

IRS E-filing Requirements

The Internal Revenue Service (IRS) released temporary and proposed regulations on January 12, 2005, that require corporations with total assets of $50 million or more to electronically file their 2005 Form 1120. For tax year 2006, the total asset requirement is reduced to $10 million or more. The regulations also address other e-filing requirements relative to tax-exempt organizations, private foundations and charitable trusts that are not within the scope of this article. The e-filing requirements apply only to entities that file at least 250 returns, including income tax (Form 1120 series), excise tax (Form 720), information and employment tax returns (Form 1099 series, Forms 940 and 941), during the year. As this new e-filing requirement is aimed at large and medium-size corporations, the insurance companies easily attain the 250-return thresholds.

It is important to note that certain specialized forms, such as Forms 1120-PC and 1120-L are not capable of being electronically filed. Accordingly, if a consolidated tax return's parent is an insurance company, the e-filing requirements do not apply.

For consolidated returns, the e-filing tax preparation software must use IRS forms for reporting data for each subsidiary (stacked returns). Section 2 of the optional procedures specifically addresses corporations that file a consolidated return (Form 1120) that include insurance subsidiaries (Forms 1120-PC and 1120-L). A corporation that files a consolidated return that includes insurance subsidiaries must file the entire consolidated return electronically with the exception of the Forms 1120-PC and 1120-L, which must be attached as PDF files.

Optional procedures published by the IRS allow certain forms and formats to be included in the e-file transmission as PDF files. The optional procedures list the forms that are allowed as PDF attachments to the e-filing and the general PDF guidelines. In addition, there are optional procedures relative to transactional data, international forms and forms not required to be filed with the return. Corporations required to file electronically may only use these optional procedures for tax year 2005. Corporations that voluntarily file electronically may **NOT** use these optional procedures. Use of these optional procedures for tax year 2006 remains under consideration by the IRS.

Two Ways to E-file

First, corporations that are required to e-file who are using paid preparers to prepare, review and sign the returns should check with them to ensure that they are IRS authorized e-file providers. Most accounting firms that prepare and review returns should be authorized with the IRS as e-file providers.

Second, for corporations that are required to e-file and are planning to e-file their own returns, the IRS recommends that they complete the online registration and application at least 45 days before they plan to file their electronic returns. Once completed and accepted, the IRS will issue an Electronic Filing Identification Number (EFIN) and an Electronic Transmitter Identification Number (ETIN). "IRS e-file for Large Taxpayers Filing Their Own Corporate Income Tax Return" (found on the IRS Web site–*www.irs.gov*) provides step-by-step instructions for registration and application for e-filing, and identifies responsibilities associated with large taxpayers.

E-filing Submissions

All required due dates for filing paper income tax returns apply to electronically filed returns. An electronically filed return is not considered filed until it has been acknowledged by the IRS, accepted for processing and a signature for the return has been received via Form 8453-C, U.S. Corporation Income Tax Declaration for an IRS e-file return. This form must be

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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.*

Thomas E. Barber is director, insurance tax services with Smart and Associates, LLP in the Devon, PA. office. He may be reached at *tbarber@smartllp.com.*

Gregory L. Stephenson is partner, insurance tax services with Smart and Associates, LLP in the Washington, D.C. office. He may be reached at *gstephenson@smartllp.com.*

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completed and signed by all required parties (corporate officer and paid preparer, if applicable), scanned into a PDF document and attached to the electronic submission. Form 8453-C is signed by a corporate officer under penalties of perjury that the return is true, correct and complete. An IRS-approved e-file tax preparation software vendor can provide instructions for including the scanned Form 8453-C with the electronic tax return.

The IRS has anticipated, in Notice 2005-88, the potential need for taxpayers to correct rejected transmissions by allowing for a transmission perfection period. If an electronically filed return, which is transmitted on or shortly before the due date (including extensions), is rejected for any reason, the return can be retransmitted and considered timely filed if accepted within 20 calendar days after the original transmission. In addition, if the electronically filed return cannot be corrected in order to comply with the electronic filing requirements, the taxpayer must file a paper return. The paper return will be considered timely filed if it is postmarked by the later of the due date of the return or 25 calendar days after the original transmission. The IRS requires that, before filing a paper return, corporations required to e-file must contact the e–Help Desk at 1-866-255-0654 for assistance in correcting rejected e-file returns.

Also within IRS Notice 2005-88 is guidance on how large corporations required to e-file can request waivers of the e-file requirements. However, the IRS has made it clear, within the optional procedures, that they will grant very few waivers.

IRS Information

An abundance of information, requirements, etc. relative to large IRS e-filing can be found on the IRS Web site at *www.irs.gov*. Click on the "e-file" logo and then click on "e-file for Large and Mid-size Corporations."

Calling All Tax Enthusiasts!

The Taxation Section has had a busy first year with the successful launch of *Taxing Times*, research projects, seminars, SOA sessions and much more! Under Barbara Gold's leadership, the Section Council plans on doing even more in 2006. But we need your help!

If you have significant tax experience and willingness to actively contribute, **THE TAXATION SECTION IS LOOKING FOR YOU!** We welcome your input and would greatly appreciate your expertise on current and planned efforts for the coming year.

If you are relatively new to taxes, say two to three years of experience, and have an interest in learning, actively participating and rubbing elbows with current tax experts, **THE TAXATION SECTION IS LOOKING FOR YOU!**

And for all those in between the tax novice and the tax expert, **THE TAXATION SECTION IS LOOKING FOR YOU!**

What are we looking for you to do?

- Develop newsletter articles on current topics.
- Participate in ongoing and proposed research.
- Discuss tax effects of Principles-Based Valuation.
- Investigate policyholder tax treatment under various new possible proposals.
- Defend current tax treatment of Life Insurance and Annuities.
- Improve the tax treatment of payout annuities.
- … or get involved in other exciting projects that surface.

As a member of the Taxation Section, you have the opportunity to be in the forefront of insurance tax issues! You just need to get involved. **THE TAXATION SECTION IS LOOKING FOR YOU AND YOU SHOULD BE LOOKING FOR US!** Contact Section Council Member Jim Reiskytl (*jimreiskytl@wi.rr.com*) today and become actively involved.

Product Tax Seminar

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 camp focused on:

- life insurance
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Days 2 and 3:

General sessions covering current product tax issues. Featured products include:

- life insurance
- annuities
- IRS remediation
- long-term care

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

Look for registration material in the mail this summer or register on-line at the SOA Web site at *www.soa.org*.

Capital Efficiency Seminar

Scottsdale, AZ
September 19–20, 2006
Co-Sponsored by the SOA Taxation, 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.

Look for registration material in the mail this summer or register online at the SOA Web site at *www.soa.org*.

COLI Update

COLI products continue to be the focus of litigation. The following two articles provide updates on two current COLI cases and their most recent court decisions. The first concerns a District Court's ruling on insurable interest, while the latter provides an update of the Sixth Circuit reversal of a trial court decision.

Court Decides Xcel Had Insurable Interest In Broad-Based COLI

by Peter H. Winslow and Susan J. Hotine

In addition to arguing sham and lack of economic substance, the IRS has begun attacking interest deductions on broad-based COLI programs by stating that the employer did not have an insurable interest in the lives of covered rank-and-file employees at the time the policies were issued. The IRS argues that the lack of an insurable interest renders the policies void as against public policy, that the policy loans are not genuine indebtedness and, therefore, that the interest deductions are not allowable. In *Xcel Energy, Inc. v. United States*, No. 04-1449 (D. Minn. 2005), the District Court rejected the government's motion for summary judgment regarding lack of insurable interest and held that Xcel Energy in fact had an insurable interest because it had a "reasonable right to expect some pecuniary advantage from a continuance of the life of [its employees], or to fear the loss from [their] death." The court's conclusion seems to have been based on a finding that the COLI program was set up to fund death benefits provided under a pre-existing employee benefit plan and the selection of the insured lives was designed to correlate to the Xcel Energy's obligations under the plan. Concluding under Colorado law that an insured has an ability to designate a beneficiary without regard to whether the beneficiary has a financial interest in the life of the insured, the court's decision also seems to have been based on the fact that Xcel Energy had received written consent from each covered employee. The court declined to apply the decisions of two recent, non-tax, cases that found the employers to not have had insurable interests in COLI. *Mayo v. Hartfold Ins. Co.*, 354 F.3d 400 (5th Cir. 2004); *Tillman v. Camelot Music, Inc.*, 408 F.3d 1300 (10th Cir. 2005). Although the government had argued that those decisions be applied in Xcel Energy's case, the court said that it was inappropriate to impose other jurisdictions' decisions on Colorado and noted that those decisions were guided by specific provisions of the applicable state (not Colorado) insurable interest law, which made the cases legally distinguishable.

It is unclear why the IRS believes that a finding that the employer lacked an insurable interest will negate an interest deduction on any policy loan. PLR 200528023 (July 15, 2005), appears to recognize that, under state law, the lack of an insurable interest on the part of the employer does not make the life insurance contract void; it states that "the life insurance proceeds received by [the employer] . . . upon the deaths of the covered employees clearly were proceeds paid by reason death." Thus, lack of insurable interest does not seem to render the policy void. Furthermore, even if there were no insurance contract, it does not necessarily follow that the loan is an economic sham. That would depend to some extent upon whether there is a realistic expectation of repayment. In addition, if the IRS is correct that there is no insurance, but nevertheless there still is a bona fide loan, one might question whether the restrictions on deductions for policy loan interest in I.R.C. § 264 even apply.

Although the government lost its bid for a summary judgment based on the insurable interest argument in Xcel Energy, as of now the case is proceeding to trial to determine whether either the COLI program as a whole or the policy loans and interest deductions separately are economic shams.

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*.

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

Sixth Circuit Overturns Taxpayer-Favorable Decision in Dow Chemical COLI Case

by Frederic J. (Rick) Gelfond

In late January, the Sixth Circuit, in *Dow Chemical v. United States*, rendered the fourth appellate level decision in an economic substance case involving the deductibility of interest associated with a broad-based purchase of life insurance by a corporation [COLI]. Despite the fact that Dow was the first taxpayer to achieve a victory at the district-court level, it fared

Rick Gelfond is a senior manager with the Washington, DC National Tax office of Deloitte Tax LLP. He may be reached at *fgelfond@deloitte.com*.

no better than the previous taxpayer-litigants on this issue, as a split panel overturned the lower court in a 2-to-1 majority decision.

Given the history of success by the government on this issue, significant attention has been paid as to whether the Dow case might be reversed on appeal; regardless of the differences in facts between Dow and the earlier cases. What is curious about the decision, however, is the manner in which the court went about rendering its decision. First, the Sixth Circuit appears to have looked past its own precedent for opining on the economic substance of a broad-based, leveraged COLI transaction, as articulated in its decision in AEP. Second, it appears to have disregarded the standard of review it was required to apply in analyzing specific factual findings of the lower court.

The Determining Factors

In analyzing the lower court's decision, the Sixth Circuit examined what it identified as three "indicators" of a lack of economic substance; namely, (1) whether the insurance arrangement involved positive pre-interest deduction cash flows; (2) whether the taxpayer would benefit from "inside build-up" of cash values in the COLI contracts; and (3) whether the transaction was mortality neutral [i.e., government parlance for elimination of risk transfer].

In AEP, the Sixth Circuit focused almost exclusively on the last of these indicators; whether a sufficient amount of risk was transferred to the insurance company. In other words, whether there was such a high degree of "experience rating" that the program was mortality neutral. In an economic substance case involving insurance, that was, arguably, the correct approach. That is, it is the transfer of risk that creates the possibility of non-tax economic effects in an insurance arrangement; and hence, imbues the transaction with economic substance.

Although the typical policyholder hopes that it will not suffer the insured-against loss, it nevertheless retains the possibility of an economic profit, or positive cash flows, if or when such event should occur; for example, if an insured under a life insurance contract dies earlier than expected. As such, given the nature of insurance, if there has been a transfer of risk, a policyholder retains a possibility of an economic profit; but it cannot be held to a standard that requires an expectation of economic profit.

In a broad-based COLI situation, the realization of economic profits, if any, will depend upon when the covered individuals die. In such instance, the only expectation, although not a certainty, is that profits, or positive cash flows, if any, on the program as a whole,

... given the nature of insurance, if there has been a transfer of risk, a policyholder retains a possibility of an economic profit; but it cannot be held to a standard that requires an expectation of economic profit.

will begin to emerge as the population of covered individuals begins to age. Those profits will emerge sooner in the event the covered individuals die earlier than expected; or not at all, if the covered individuals live significantly longer than expected.

This principle holds true regardless of whether the transaction is examined on a pre- or post-tax basis, and irrespective of whether the premiums are paid through debt or equity financing.

In contrast, in Dow, the Sixth Circuit initially focused on illustrations that showed that the taxpayer might never achieve positive pre-tax deduction cash flows absent a contingent payment of cash scheduled to be made around the eighteenth policy year. Despite its near exclusive focus on the issue of risk transfer in AEP, the court does not explain its shift in emphasis in Dow to the issue of whether there was a possibility of positive pre-tax deduction cash flows.

The Standard of Review

In addition, establishing the standard it would apply in reviewing this case, the Sixth Circuit indicated that it was required to apply a *de novo* standard of review for purposes of determining the overall characterization of the transaction. It also acknowledged, however, that the specific factual findings of the lower court were subject to a clearly erroneous standard of review. Nevertheless, the court failed to apply the latter standard when examining the lower court's factual findings.

For example, even if one were to accept the notion that positive pre-tax deduction cash flows are a reliable indicator of economic substance in an insurance transaction, the lower court found, as a matter of fact, that the Dow program did involve positive pre-tax deduction cash flows. The Sixth Circuit, however, disregarded this finding, suggesting that it was dependent on the above mentioned infusion of cash by the taxpayer around the eighteenth policy year.

The court did not suggest that this factual finding of the lower court was "clearly erroneous," a fairly high

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standard to meet. Rather, it stated that the contingent future infusion of cash was irrelevant as a matter of law. Based on a strained reading of Knetsch, in which the Supreme Court found that the taxpayer in that case did not intend to make a contingent future payment, the Sixth Circuit created the following new standard:

> Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct.

In creating this standard, the majority avoided having to challenge the factual finding of the lower court. As noted by the dissent, however:

> [T]here is no such precedential rule of law and no warrant for creating one in this case.
>
> . . .
>
> [M]y colleagues read into Knetsch far more than the Supreme Court wrote in that case concerning the Court's refusal to accept the taxpayer's argument [regarding a potential future loan payoff].
>
> . . .
>
> The Court did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry, when that investment is greater than the past investment in that plan. The question is what the taxpayer intended.

In Dow, the lower court found that the taxpayer intended to make the future contingent payment. The majority, however, did not take on the question of whether this factual finding was clearly erroneous.

Similarly, the district court concluded that Dow's COLI plans had features that were designed to reduce, but not eliminate, the mortality risk transferred to the insurers. In doing so, it distinguished the Dow facts from the previously litigated broad-based, leveraged COLI cases noted above that it found involved features that resulted in a 100-percent elimination of mortality risk transfer.

The Sixth Circuit found, however, that the lower court's 100-percent standard was too high a hurdle to set as a prerequisite to finding that Dow's plans were designed to neutralize mortality gains. It then stated that the features of the Dow plans are sufficiently similar to the other COLI-plan cases for it to conclude that Dow would not significantly benefit from mortality gains; i.e., there was insufficient transfer of mortality risk.

Even if the plans in the other COLI cases did not meet the 100-percent standard—and the Sixth Circuit contended they did not—the lower court nevertheless found, as a matter of fact, that the Dow program did involve a sufficient amount of risk transfer. The Sixth Circuit, however, once again does not refer to any evidence that suggests that this finding is clearly erroneous; the requisite standard for overturning a factual finding. Moreover, while it states that none of the other COLI programs met the 100-percent risk-elimination standard, the Sixth Circuit does not provide any indication as to where it drew the line in determining whether the transaction involved a sufficient amount of mortality risk transfer.

Conclusion

While some may continue to debate the merits of the court's decision, or the manner in which it was decided, the practical reality is that most taxpayers that were involved in transactions similar to those that were the subject of the recent litigated COLI cases, have settled their matters with the government. Nevertheless, the proper manner in which to decide upon the economic substance of an insurance arrangement is a question that does not appear as though it is going to disappear from the public eye any time soon. Each of the above cases involved contracts that were issued subsequent to June 20, 1986, the effective date of legislation that affected the manner in which those transactions were structured.

The Internal Revenue Service, however, has now begun to challenge several taxpayers on their interest deductions relating to contracts issued on or before that date. In fact, the first case involving these "pre-1986" COLI arrangement is expected to go to court early next year. Given the fact that Congress has preserved the deductibility of interest on debt related to pre-1986 contracts, not to mention the significant differences between the pre-1986 cases that are currently under scrutiny and the post-1986 arrangements that have been litigated, it will be interesting to see how, if at all, the standards established by the courts in analyzing the post-1986 cases affect the manner in which the pre-1986 cases might be resolved.

2001 CSO Implementation Under IRC Sections 7702 and 7702A

2001 CSO Maturity Age Task Force

Section 7702 of the Internal Revenue Code (the Code) places limits on the investment orientation of life insurance contracts, either by restricting the allowable premium paid into the contract or by mandating minimum death benefits, or both. It also places restrictions on the assumptions underlying the calculation of these limits. With respect to mortality, the tax law allows the use of "reasonable mortality" in computing these limitations, and specifies the prevailing CSO table as an upper limit on reasonable mortality.

For tax testing of policies issued on or after January 1, 2009, the 2001 CSO Mortality Table is required. There are several characteristics of the 2001 CSO table that distinguish it from prior CSO tables, most notably the extension of the table beyond age 100. Because the 2001 CSO table extends to age 121, it's likely that companies will be developing contracts with maturity dates beyond age 100. This will raise some fundamental questions regarding how such contracts should be administered under Section 7702 and 7702A. Many of these questions are linked to the computational rules of Section 7702(e)(1), which limit the future benefits that can be incorporated into the calculation of guideline and net single premiums. Of particular note is Section 7702(e)(1)(B) which provides that the maturity date assumed in the calculations can be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100.

The insurance industry has requested guidance from the Treasury Department and the Internal Revenue Service on the proper application of the current computational rules to the 2001 CSO Mortality Table but, to date, such guidance has not been provided. Therefore, the Taxation Section established the 2001 CSO Maturity Age Task Force to propose methodologies that would be actuarially acceptable under Sections 7702 and 7702A of the Code for calculations under contracts that do not provide for actual maturity before age 100. The task force recommendations are as follows:

- Calculations will assume that all contracts will pay out in some form by age 100, as presently required by the Code, rather than by age 121 as would occur "naturally" under the 2001 CSO.
- The net single premium used in the cash value accumulation test corridor factors, of Section 7702(b) of the Code, and the necessary premium calculations, of Section 7702A(c)(3)(B)(i) of the Code, will be for an endowment at age 100.
- The guideline level premium present value of future premium calculations, of Section 7702(c)(4) of the Code, will assume premium payments through attained age 99.
- The sum of guideline level premiums, of Section 7702(c)(2)(B) of the Code, will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit, but the sum of guideline level premiums will not increase. If the guideline level premium is negative, the sum of guideline level premiums will also not decrease after age 99.
- In the case of contracts issued or materially changed near to the insured's age 100, the MEC present value of future premium calculations will assume premium payments for the lesser of seven years or through age 99. This is the case because the computational rules of Section 7702A(c)(1) provide: "Except as provided in this subsection, the determination under subsection (b) of the 7 level annual premiums shall be made … by applying the rules … of section 7702(e)," suggesting a need for a new seven pay premium. However, since Section 7702(e)(1)(B) requires a maturity date of no later than the insured's attained age 100, it arguably overrides the computational rules of Section 7702A(c)(1) and thus the calculations would end at age 100. Given the lack of guidance, reasonable alternative interpretations may also be available on this point.
- If the MEC present value of future premium calculations assumes premium payments through age 99 because this is less than seven years, the sum of the MEC premiums will continue to increase through attained age 99. Thereafter, premium payments will be allowed and will be tested against this limit for the remainder of the seven-year period, but the sum of MEC premiums will not increase after age 99.
- In the case of contracts issued or materially changed near to the insured's age 100, followed by a reduction in benefits, the MEC reduction rule, of Section 7702A(c)(2), will apply for seven years from the date of issue or the date of the material change for a single life contract. For contracts insuring more than one life, the MEC reduction rule, of Section 7702A(c)(6), will apply until the youngest insured attains age 121.
- Adjustments that occur on or after attained age 100 will not necessitate a material change for MEC testing purposes or an adjustment event for guideline premium purposes.
- Necessary premium/deemed cash value testing, of Section 7702A(c)(3)(B)(i) of the Code, will cease at attained age 100.
- Policies can remain in force after age 100 with a death benefit greater than or equal to the cash value.

Members of the 2001 CSO Maturity Age Task Force are Kyle Gelormini, Barbara Germann, Barbara Gold, Brian Lessing, Carol Meyer, Jerry Norman, Brian Prast, Kenneth Reeves, Bruce Schobel, Catie Smith, Craig Springfield, Dan Stringham and Tim Wuestenhagen.

The Demise of Sections 809 and 815

by William B. Harman, Jr., Bryan W. Keene and Douglas Hertz

Congress has acted in recent years to remove outdated provisions governing the federal income taxation of life insurance companies from the Internal Revenue Code. In particular, section 809 and section 815 were repealed and suspended, respectively, in 2004.[1] These legislative actions were commendable, as they eliminated two archaic provisions that were based strictly on events and circumstances of the distant past and that did not comport with the present-day reality of how life insurance companies are structured and taxed. This article chronicles the demise of these provisions and explains why Congress was right in removing them from the Code.

The "Segment Balance" Roots of Sections 809 and 815

Code sections 809 and 815 each shared the same fundamental goal—to distribute the overall tax burden of the life insurance industry in a way that would not disturb the competitive "balance" between the stock and mutual "segments" of the industry. These "segments" are based on a historical distinction in the form of business organization within the life insurance industry. Stock life insurance companies have distinct classes of owners and customers, and thus adhere to the general business corporation model. Under that model, the owners of the company (*i.e.*, shareholders) expect to share in the profits generated by the corporation's sale of products or services to customers, and the corporation's distribution of such profits to the shareholders is not deductible by the corporation. On the other hand, distributions to customers solely in their capacity as such, *e.g.*, by way of price rebates, are merely considered reductions in profits and thus are deductible by the corporation. In contrast, mutual life insurers have a single group of persons who are both their owners and customers, *i.e.*, their customers *are* their owners, and, thus, they adhere to the general model for "cooperatives."[2] Under that model, distributions of earnings as "patronage dividends" are deductible by the corporation,[3] and thus are not subject to tax at the level of the cooperative.

This difference in the tax treatment of corporations and cooperatives led Congress to conclude in both 1959 and 1984 that a competitive problem could arise between the stock and mutual segments of the industry depending upon the tax treatment of policyholder dividends.[4] In both 1959 and 1984, mutual companies were dominant in the life insurance industry, which prompted Congress to make adjustments to life insurers' income tax base in an effort to avoid placing tax-based competitive disadvantages upon either segment of the industry. Hence, in developing industry-wide rules for the taxation of life insurers in each of those years, Congress chose one segment of the industry on which to base the rules and established "adjustments" that it deemed necessary to eliminate any competitive

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1 Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

2 *See* Staffs of the J. Comm. on Tax'n and Senate Comm. on Finance, Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies, at 27 (J. Comm. Print 1983) ("1983 Study") (stating that "[s]tock life insurance companies, like other corporations, have customers (policyholders) and owners (stockholders). Unlike stock companies, mutual life insurance policyholders alone benefit from favorable investment and underwriting experience, since there is no separate group of equity owners").

3 *See* section 1382.

4 See 1983 Study, *supra* note 2, at 10 (stating that this "competitive problem is usually discussed in the context of what portion of policyholder dividends should be deductible to a mutual company as a business expense and what portion, if any, is analogous to a stockholder dividend as a return on invested capital to be paid out of after-tax earnings."); S. Rep. No. 86-291, at 10-11 (1959) ("1959 Senate Report") (stating that "the basic question is whether amounts which are distributed back to the policyholders as dividends are properly a part of the life insurance company's tax base," and recognizing that an unlimited deduction for mutual company policyholder dividends could result in a "competitive problem between stock and mutual companies…."). *See also* 50 Cong. Rec. 512-14 (1913) (statements of Rep. Hull, debating the same segment balance point).

advantage or disadvantage that the choice was perceived to place upon the other segment. In 1959, the life insurance company tax rules were based on a mutual company model, and section 815 represented the downward "adjustment" to the tax burden of stock companies that Congress thought necessary to maintain segment balance.[5] In 1984, Congress structured the life insurance company tax rules on a stock company model, and section 809 represented the upward "adjustment" to the tax burden of mutual companies that Congress deemed necessary from a segment balance perspective, and section 815 was kept on the books to ensure Congress' past efforts at segment balance would remain intact.[6]

How Sections 809 and 815 Were Intended to Achieve Their Segment Balance Goals

The Segment Balance Approach in 1984

Because the structure of the life insurance company tax rules was based on a stock company model in 1984, Congress concluded at that time that the policyholder dividend deductions of mutual life insurers should be limited in order to make the portion representing a distribution of corporate earnings nondeductible. Thus, section 809 acted to limit mutual company deductions in this manner. However, because Congress also concluded that there was no accurate method of segregating and measuring the corporate-earnings portion of a dividend payment for each company,[7] it decided to base the limitation on a comparison of the profitability of the mutual and stock segments of the industry.

In doing so, Congress concluded that any difference between the earnings rates of the mutual and stock segments was attributable to the extent that policyholder dividends operated to reduce the mutuals' net income below the profitability they might have had if they had been stock companies.[8] Section 809 attempted to implement this conclusion by reducing a mutual company's dividend deductions by a "differential earnings amount," defined as the product of the company's "average equity base" and a "differential earnings rate." The differential earnings rate, in turn, was determined (by the Internal Revenue Service (the Service)) as the difference between the average earnings rates of the stock and mutual segments of the life insurance industry, after deducting all policyholder dividends.[9]

The Segment Balance Approach in 1959

In contrast to the approach taken in 1984, because the structure of the life insurance company tax rules was based on a mutual company model in 1959, Congress concluded at that time that adjustments should be made to the taxation of stock companies. In this regard, the 1959 Act implemented a complex "three-phase" system of life insurance company taxation under which earnings from both investment and underwriting activities were included in a company's tax base.[10] Under this approach, both mutual and stock life insurance companies incurred an initial tax liability measured by their "total income." However, for the reasons discussed here, that initial liability could be affected substantially by the manner in which policyholder dividends were treated. Rather than dealing with this issue by attempting to differentiate the component parts of a dividend (as was attempted in the 1984 Act), the 1959 Act merely limited deductions in gross. This was accomplished by specifying (in effect) that the deduction of policyholder dividends could not

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[5] *See* Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69 (the "1959 Act"). For a detailed discussion of the 1959 Act, see William B. Harman, Jr., *The Pattern of Life Insurance Company Taxation Under the 1959 Act*, Fifteenth Annual Tulane Tax Institute (1965).

[6] See Deficit Reduction Act of 1984, Pub. L. No. 98-369 (the "1984 Act"). For a detailed discussion of the 1984 Act, see William B. Harman, Jr., *The Structure of Life Insurance Company Taxation—the New Pattern Under the 1984 Act*, Journal of American Society of CLU, March 1985, at 56 (Part I) and May 1985, at 76 (Part II).

[7] *See* S. Prt. No. 98-169, Vol. I, at 549 (1984).

[8] *See id*. This conclusion was based on Congress' assumption that the mutual and stock segments of the life insurance industry have identical earnings rates, and that all profit-oriented enterprises distribute earnings to their owners in proportion to the owners' equity in the enterprise.

[9] In general terms, the earnings differential under section 809 was calculated by comparing (1) the arithmetic average of the stock segment's earnings rates (determined by looking to a sample of the stock companies, *i.e.*, the 50 largest stock company affiliated groups) for the three years preceding the taxable year, with (2) the weighted average earnings rates of all mutual companies for the immediately preceding year (subsequently "trued up" to reflect the mutuals' earnings for the current year). Further, while actual earnings rates were used for the mutual segment in computing this difference, an "imputed earnings rate" was used for the stock segment, an indexing of a 16.5 percent rate chosen to fix the segment balance.

[10] Prior to 1959, life insurance companies were taxed only on their free investment income, leaving their underwriting income free of any tax burden.

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reduce a life insurer's "total income" tax base more than $250,000 below a free investment income floor.[11] Because mutual companies could make use of policyholder dividends to reduce their tax base down to their free investment income under the 1959 Act, underwriting income would be eliminated from their tax base. However, because stock companies typically issued nonparticipating contracts, they generally had no policyholder dividends to deduct, meaning that they could not eliminate their underwriting income from their tax base in this way, or even reduce it to a meaningful extent. In an attempt to address this discrepancy and preclude any perceived competitive disadvantages it could cause within the industry, Congress enacted a variety of segment balance provisions, including section 815.[12]

In this regard, the 1959 Act taxed one-half of a company's net underwriting income on a current basis. According to section 815, the other half was to be recorded in a memorandum account known as the "policyholders surplus account" (PSA). The untaxed half of the stock company's net underwriting income was not to be subjected to tax until (and unless) section 815 treated it as distributed to the company's shareholders. Because amounts were deemed to be distributed from a company's PSA (1) only after actual (or deemed) distributions to the shareholders exceeded the totals in the "shareholders surplus account" maintained by the company,[13] or alternatively (2) only after certain intentionally high thresholds were exceeded,[14] the reality was that amounts typically would be treated as coming out of a PSA only upon dissolution or liquidation of the company.

The three-phase system of life insurance taxation remained in effect until 1984, when Congress replaced it with a single-phase approach that applies today. Under the 1984 Act, further PSA accumulations were discontinued, and underwriting income became fully taxable to both stock and mutual companies in the year it was earned. Significantly, the amounts in the PSAs were "frozen;" they were not brought into taxable income, but merely were allowed to enjoy the *status quo*. Also, to preserve that *status quo* (*i.e.*, non-taxation of the PSA amounts), the 1984 Act directed that the shareholders surplus accounts and the elements comprising the other thresholds generally should continue to grow as before.[15]

Criticisms of Sections 809 and 815

The most compelling criticism of sections 809 and 815 has been one that applies equally to both, namely, that they were outdated provisions based strictly on events and circumstances of the distant past that did not comport with the present-day reality of how life insurance companies are structured and taxed.[16] Unlike the circumstances in 1959 and 1984 when sections 815 and 809 were enacted, mutual companies no longer represent the dominant segment of the life insurance

[11] Congress determined that mutual companies, which at the time accounted for approximately 63 percent of the life insurance in force and 75 percent of the total assets in the life insurance industry, would carry an appropriate portion (69 percent) of the industry's total tax burden under the then-new regime, clearly indicating that the limitations on policyholder dividend deductions of mutual companies were aimed at achieving segment balance. *See* 1959 Senate Report, *supra* note 4, at 10.

[12] In the words of the Staffs of the Joint Committee on Taxation and the Senate Finance Committee in their 1983 pamphlet, "[u]nder the 1959 Act, the differences between mutual companies and stock companies are taken into account, and the relative tax burdens of the mutual and stock segments of the industry effectively are established by means of three special deductions *and a provision permitting a life insurance company to defer the tax on one-half of its underwriting gain*." 1983 Study, *supra* note 2, at 36-37 (emphasis added).

[13] *See* section 815(b) and 1959 Code section 815(a)(1). The shareholders surplus account is a tax-paid account consisting of taxable income and (to the extent not included in taxable income) long-term capital gains, together with certain intentionally untaxed amounts. *See* section 815(c) and 1959 Code section 815(b)(2)(A)(i), (ii), (iii), and (iv).

[14] In general, these thresholds were (A) 15 percent of life insurance reserves at the year end; (B) 25 percent of the excess of life insurance reserves at year end over such reserves at the end of 1958; or (C) 50 percent of the net amount of premiums and other consideration taken into account for the year under 1959 Code section 809(c)(1) (defining premiums for purposes of calculating "gain from operations").

[15] *See* section 815(c), (f).

[16] *See* William B. Harman, Jr., John T. Adney, and Bryan W. Keene, *The Taxes on Starlight: The Case for the Repeal of Sections 809, 815, and 1503(c) of the Internal Revenue Code*, 20 Ins. Tax Review 31 (January 2001).

industry.[17] Moreover, the enactment of the Gramm-Leach-Bliley Act of 1999[18] modernized the rules of competition and affiliation within the entire financial services industry. This modernization has caused a significant movement of assets and companies from the mutual to the stock segment of the industry through demutualizations and the creation of mutual holding companies with stock subsidiaries. As a result of these changes in the life insurance industry, an approach to taxation that looks solely to one part of that overall industry is clearly inappropriate and antiquated. Consequently, the segment balance provisions embodied in sections 809 and 815 could not serve to ensure tax equity between segments of the life insurance industry, but instead served to create uncertainty and to hinder the industry's ability to function in an increasingly global financial services marketplace. These factors, along with the fact that neither section has been a source of significant tax revenue for the federal government, ultimately led to their repeal and suspension.

The Repeal and Suspension of Sections 809 and 815

In 2002, Congress began to recognize that the segment balance functions served by sections 809 and 815 were no longer needed or appropriate due to significant changes in the organization and taxation of the life insurance industry. Hence, it passed the Job Creation and Worker Assistance Act of 2002, which suspended section 809 for taxable years beginning in 2001, 2002 and 2003.[19] Two years later, Congress passed the Pension Funding Equity Act of 2004, which repealed section 809 effective for taxable years after December 31, 2004, leaving 2004 as the only year since 2001 that section 809 was operative. However, the Service subsequently issued guidance indicating that the differential earnings rate and the recomputed differential earnings rate for 2004 were both zero, thereby eliminating any remaining impact of section 809.[20] We can all be thankful that a code provision that deeply divided the industry for many years, both in its enactment and in its operation, and, ironically, raised significant revenue in only four of the years from 1984 through 2004, is now a historical anomaly.

In the same year that section 809 was repealed, Congress passed the American Jobs Creation Act of 2004.[21] A provision of the new law added subsection (g) to section 815 for taxable years beginning after December 31, 2004, and before January 1, 2007, pursuant to which distributions to shareholders from PSAs are treated as zero and providing that any distributions to shareholders during these years are treated as first coming from a company's PSA, then from its shareholders surplus account, then other accounts. These provisions effectively repealed section 815, since they allow stock companies to eliminate their PSA balances during the two-year suspension period.

The fact that section 809 was repealed and section 815 was effectively repealed in the same year reveals that the fundamental reason for taking these actions was a determination by Congress that the provisions were antiquated and no longer served any legitimate purpose. It is a worthwhile goal to remove provisions from the Code once they become outdated relics with no modern rationale to support their continued existence. Many in the industry have argued that there are other Code provisions that share this fundamental flaw, such as the current-law restrictions that limit a life insurance company's ability to file a consolidated federal income tax return with its non-life insurance company affiliates, and limit the use of losses of these non-life insurance entities against income of life insurance company affiliates. Will Congress turn to these provisions next? ◂

William B. Harman, Jr. is a partner with the Washington, D.C. law firm of Davis & Harman LLP. He may be reached at *wbharman@davis-harman.com.*

Bryan W. Keene is a partner with the Washington, D.C. law firm of Davis & Harman LLP. He may be reached at *bwkeene@davis-harman.com.*

Douglas Hertz, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. He may be reached at *doug_hertz@aon.com.*

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[17] In 2003, stock life insurance companies held approximately 81 percent of industry assets, compared to approximately 16 percent for mutual companies. In that year, stock companies also accounted for approximately 91 percent of the total number of life insurers doing business in the United States (compared to approximately 8 percent for mutual companies) and approximately 84 percent of the life insurance in force (compared to approximately 10 percent for mutual companies). The figures for mutual companies include stock companies owned by mutual holding companies. American Council of Life Insurers, Life Insurers Fact Book 2-3 (2004). Compare the figures discussed in note 11, *supra*.

[18] Pub. L. No. 106-102.

[19] Pub. L. No. 107-147. Technically, the act treated the differential earnings amount and the recomputed differential earnings amount as zero for these years.

[20] *See* Notice 2005-18, 2005-9 I.R.B. 634, and Revenue Ruling 2005-58, 2005-36 I.R.B. 465 (regarding the differential earnings rate); Notice 2006-18, 2006-8 I.R.B. 502 (regarding the recomputed differential earnings rate).

[21] Pub. L. No. 108-357. A Senate amendment to the bill that became the American Jobs Creation Act would have repealed section 809 for the 2004 tax year, but it was not included in the conference agreement.

Rev. Proc. 2006-13: Valuation of Deferred Annuities in Roth IRA Conversions

by Douglas Hertz

Roth IRA Conversions

Recent guidance in the form of Rev. Proc. 2006-13 provides a general safe harbor for the fair market value of a deferred-annuity contract when determining the amount includible in income on conversion of a traditional IRA to a Roth IRA. Generally, where property is involved in such a conversion, the amount includible for the property is its fair market value at the time the property is considered distributed from the traditional IRA. (See A-14 of §1.408A-4T.)

The subject of the valuation of deferred annuities and their additional benefits is never easy. Avid followers of *Taxing Times* may recall an article by Joe McKeever and Mark Griffin in Vol. 1, Issue 2 (Sept. 2005), on the valuation of deferred annuity contracts held in qualified trusts for purposes of determining the amount of the required minimum distribution (RMD) under section 401(a)(9), and Treas. Reg. §1.401(a)(9)-6, Q&A-12. Generally, for RMD purposes, the "entire interest" under a deferred annuity contract is the sum of the "dollar amount credited" to the employee or beneficiary, not reduced by any applicable surrender charge, plus the "actuarial present value" of any additional benefits provided under the contract. In the RMD case, certain benefits ("Pro-Rata reduction" benefits, which reduce in an at least pro-rata fashion when there is a distribution from the annuity account, and Return of Net Premium on death benefits) may, in certain circumstances, be disregarded in the valuation. (See the McKeever-Griffin article for details.)

The general safe harbor offered by Rev. Proc. 2006-13 is provided by a modification of the method under A-12 of §1.401(a)(9)-6 for RMDs. This safe harbor will be allowed at least until further guidance is issued. The modifications presumably reflect the differing purposes of the valuations. A-12 of §1.401(a)(9)-6 is for purposes of determining the amount of a required distribution, with the intent of liquidating the entire interest of the employee over the life expectancy of the employee (or, perhaps, of the employee and a designated beneficiary). On the other hand, Rev. Proc. 2006-13 seeks to determine the full fair market value for current taxation. RMD valuation treats favorably some benefits that reduce when distributions are made and ignores "sunk costs" such as front-end loads, where full fair market valuation would not do this. The modifications are:

1. Front-end loads and other non-recurring charges assessed in the 12 months preceding conversion must be added to the account value.

2. Future distributions are not to be assumed in determining the actuarial present value of additional benefits.

3. The exclusions under paragraphs (c)(1) and (c)(2) of A-12 (limited pro-rata reduction benefits and return of net premium on death benefits) are not to be taken into account.

Finally, a simplified safe harbor applies for conversions that occurred in 2005. In this case, modifications two and three above may be disregarded, but modification one must still be made.

Douglas Hertz, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. He may be reached at *doug_hertz@aon.com.*

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