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# Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM

*by Edward L. Robbins and Peter H. Winslow*

One of the goals of the Taxation Section of the Society of Actuaries and of *Taxing Times* is to broaden the dialogue among the professional disciplines on tax issues of common concern. For this reason, the Taxation Section has opened its doors to tax accountants and tax lawyers and both of these professions are represented on *Taxing Times'* Editorial Board. It is in that spirit that we offer our first interdisciplinary dialogue on the topic of principles-based reserves (PBR) between Peter Winslow, a tax attorney, and Edward Robbins, a tax actuary and current SOA President. The opinions expressed in this dialogue are solely those of Mr. Winslow and Mr. Robbins.

**Peter:** Ed, the annual statement reports income before tax, then adjusts for taxes below the line. The current version of principles-based reserves appears to require that PBR should not consider federal income taxes. There has been much discussion as to whether this approach is correct or whether, instead, taxes should be treated as an expense liability in PBR. What is the right answer?

**Ed:** I'm glad you asked. The short answer is that statutory PBR should be pre-tax. The best "sound-bite" answer is that "taxing a post-tax number is inappropriate." To have a reserve that reflects post-tax cash flows, and then to tax the change in those reserves is not correct.[1]

**Peter:** I'm not sure whether I will be able to understand your response to this, but is your conclusion, that PBR should be pre-tax, mathematically provable?

**Ed:** Absolutely. But rather than go through the details of the algebraic proof, let me just say that interested parties can find the mathematical proof in the October 2006 issue of the *Actuarial Practice Forum*, now available on the Society of Actuaries Web site, in the article entitled "Treatment of Taxes in Principles-Based Reserves." Instead, let's go through a simple case. Assume a one-year insurance obligation, such as one-year term insurance. The reserve is $100 at the end of year one, and the benefit cost in year two turns out to be $90, for a pre-tax profit of $10 in year two. Ignoring interest, and assuming that the tax basis reserve equals the statutory reserve, the year two tax at 35 percent equals 35 percent of ($100) minus 35 percent of $90, or $3.50. Thus the post-tax

continued ⟫ 4

[1] The advent of the deferred tax on the statutory balance sheet as a result of codification in 2001 is one of the drivers that make a post-tax reserve calculation inappropriate. The fact that the incremental deferred tax asset arising from reserves was not inserted into the authoritative statutory guidance until Codification is one of the reasons that the AOMR asset adequacy testing was originally designed to be post-tax, while the statutory reserve in the current environment should be pre-tax.

⟫ contents

Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM
*Edward L. Robbins and Peter H. Winslow* — 1

From the Editor
*Brian G. King* — 2

From the Chair
*Leslie J. Chapman* — 3

More on Reasonable Mortality: IRS Issues Notice 2006-95
*Brian G. King, John T. Adney and Craig R. Springfield* — 10

New "Best Practices" Rules for Corporate-Owned Life Insurance
*John T. Adney and Bryan W. Keene* — 15

FIN 48—An Interpretation
*Frederic J. Gelfond* — 22

Role of Outside Tax Advisors in FIN 48 Compliance
*Peter H. Winslow* — 30

T³: *Taxing Times* Tidbits — 32

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SOCIETY OF ACTUARIES

# FROM THE EDITOR

BRIAN G. KING

Hello readers and welcome to another exciting year of *Taxing Times* We have had a long break between this issue and our last, published in September of 2006. This was due to the Society of Actuaries (SOA) publication schedule, rather than a lack of tax topics. In fact, the summer and fall of 2006 proved to be a busy time of year. From seminars to the adoption of legislation and regulations, and the ongoing dialogue surrounding principles-based reserves, much has happened in the insurance tax arena, making this current issue overflowing with the latest updates and information.

Let me begin with a recap of some of the highlights of this past fall. The biggest events of fall 2006 were the tax seminars sponsored by the SOA Taxation Section. These seminars provided an outstanding platform to introduce our section to many professionals in a number of disciplines. This fosters and enhances our section goal of exchanging and developing tax knowledge in a cross-discipline environment.

The Product Tax Seminar held in Washington, D.C. this past September is just one example of the seminars sponsored by our section. By all accounts, this seminar was a huge success and we owe a big thank you to the many participants who contributed in its planning, implementation and outcome. Primary amongst these participants was the IRS, the Treasury and the ACLI for their contributions in making this a successful program. The input and assistance from these entities deserve special recognition and appreciation. Specifically, the Taxation Section seminars are recognized as a good forum to foster discussion on industry tax issues. By releasing guidance in the form of a final regulation during this seminar, the IRS and Treasury acknowledge that this forum, our section and discussions that arise at our meetings can go far in fostering a greater understanding of tax regulations among the industry. IRS, Treasury and ACLI participation at our seminars further enhances this understanding and provides an opportunity for questions and clarifications. Thank you to all three of these organizations for working with us on the seminars this fall

## Note From The Editor

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

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

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

Brian G. King

Finally and not surprisingly, much of the legislation, regulations and guidance passed this summer and fall, and discussed at our seminars, have found their way into the articles for this and our upcoming May issue of *Taxing Times* The Pension Protection Act of 2006 signed into law last summer impacts tax rules governing corporate owned life insurance (COLI) products and long-term care (LTC) combination products. In addition, concerning IRC section 7702 compliance, regulations provide guidance for attained age determination and Notice 2006-95 provides further clarification for meeting the reasonable mortality requirements. The articles in this and the May issue will provide more details and hopefully greater insights into all of these legislative and regulatory changes. Enjoy!

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

LESLIE J. CHAPMAN

The Taxation Section of the Society of Actuaries (SOA) is entering its third year with a great deal of momentum! Under the excellent leadership of Barbara Gold during this past year, the section council has moved from primarily dealing with the tactical management of an SOA section to strategically planning 1) how to grow our membership as well as 2) ways to enhance the value we deliver to those members.

The section is using our flagship product, *Taxing Times*, as a tool to grow our membership and enhance value. This newsletter, under the top-notch direction of Brian King, provides our members with high-quality education and analysis regarding tax topics.

Additionally, the section is focusing on developing continuing education opportunities for its members; we will have excellent tax-related sessions at each of the SOA meetings in 2007 In addition, we will co-sponsor seminars with other SOA sections throughout the year. As a member, you will receive e-mail reminders of these opportunities!

One of the ways that we ensure that the tax sessions/seminars that we sponsor are relevant is to regularly scan the environment for emerging tax issues. During 2007 we will focus on developing the research and education that is needed on key emerging tax issues

And, speaking of education, our section is committed to contributing to the redesign of the FAP and FSA exams and modules; we will continue our efforts to address the education needs of actuarial students by helping to develop the tax-related content of the modules/exams.

2007 promises to be a challenging and exciting year for the Taxation Section With the momentum created under Barbara's leadership and with the addition of three new Council Members—Kory Olsen, Chuck Miller & Cherri Divin—we are well-positioned to enhance our section's membership value

Thank you, Barbara! And welcome to our new council members!

Leslie J. Chapman, FSA, MAAA, is vice president and corporate actuary with Securian Financial Group in St Paul, Minn She may be reached at *leslie chapman@securian.com.*

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profit of $6.50 is 65 percent of the $10 pre-tax profit. That is the appropriate result.

Now let's assume on the contrary that the statutory reserve and tax basis reserve are post-tax. So the year one ending reserve now equals 65 percent of $100. We now have a post-tax reserve of $65 matched against pre-tax claims of $90. That gives us a pre-tax profit of "minus $25," and a tax of "minus $8.75," for a post-tax profit of "minus $16.25," demonstrating that we clearly have not made provision at the end of year one for the net cash outflows.

You might respond to me that, even though the statutory reserve is post-tax, the tax reserve itself should be pre-tax. Well let's examine that. So the statutory reserve is $65 and the tax reserve is $100. Now we have a positive net tax (i.e., $3.50) instead of the above negative net tax (i.e., minus $8.75). That makes our net post-tax profit even more negative, clearly showing again that the statutory reserve so calculated is inappropriate.

**Ed:** One of the potential tax issues that is most frequently raised about PBR is whether—or to what extent—they will qualify for tax purposes as CRVM reserves. Peter, please explain why this is an issue under the Internal Revenue Code.

**Peter:** I'm going to give the long version of the answer to your question by starting with a primer on tax reserves. The computation of life insurance reserves under Section 807(d) of the Internal Revenue Code involves a two-step approach. An actuarial reserve is first computed (the Federally Prescribed Reserve or (FPR)), on a contract-by-contract basis, and then this reserve is compared to the net surrender value of the contract. The larger amount is the tax reserve, except that in no event can the amount of the tax reserve exceed the amount of statutory reserve as defined in Section 807(d)(b). "Statutory reserve" for this purpose generally refers to the aggregate amount of reserves for the contract which are set forth in the company's annual statement.

To compute the FPR, a company begins with its statutory reserve and modifies that reserve to take into account six adjustments: (1) the "tax reserve method" applicable to the contract, (2) the greater of the applicable Federal interest rate or prevailing State assumed interest rate, (3) the prevailing commissioners' standard tables for mortality or morbidity, (4) the elimination of any portion of the reserve attributable to net deferred and uncollected premiums, (5) the elimination of any portion of the reserve attributable to excess interest guaranteed beyond the end of the taxable year, and (6) the elimination of any deficiency reserve. In general, except for these prescribed adjustments, the assumptions employed in computing the tax reserve should be consistent with those employed in computing the company's statutory reserve.

Each of these prescribed adjustments to statutory reserves raises interesting issues when applied to PBR. Your question relates to the first adjustment I mentioned—the reserve method. Let me turn to that.

Section 807(d)(3) of the Code provides that the "tax reserve method" for life insurance contracts is the Commissioners' Reserve Valuation Method (CRVM), for annuity contracts it is the Commissioners' Annuities Reserve Valuation Method (CARVM), and for noncancellable accident and health insurance contracts it is a two-year full preliminary term method. Importantly, CRVM and CARVM only apply for contracts covered by CRVM and CARVM. For all other types of contracts, the reserve method prescribed by the National Association of Insurance Commissioners (NAIC) must be used or, if the NAIC has not prescribed a method, then a method consistent with the most appropriate of the prescribed reserve methods is to be used.

Now, to address your question. If the NAIC changes the Standard Valuation Law to label PBR as CRVM reserves, will the stochastic reserve and/or the deterministic reserve be considered a CRVM reserve for tax purposes? There are several opinions on this. One school of thought is that PBR are so far removed from what

Congress thought CRVM reserves were when it enacted Section 807(d) in 1984 that PBR will not qualify as CRVM reserves for tax purposes. Under this approach, the thinking goes, Congress could not have intended to delegate to the NAIC carte blanche to designate the amount of the deduction for tax reserves simply by labeling the reserve method as CRVM. A second school of thought is that, in fact, Congress did just that and, therefore, both the stochastic reserve and the deterministic reserve should qualify as CRVM reserves. Yet a third school of thought forges a middle ground; these folks accept the principle that Congress did not delegate unlimited power to the NAIC to determine tax reserves, but that, at a minimum, the deterministic reserve should qualify because it exhibits the essential characteristics of CRVM reserves I fall into the second category. I believe that Congress delegated to the NAIC the determination of the proper tax reserve method as long as the reserves otherwise satisfy the definition of life insurance reserves in Section 816(b) of the Internal Revenue Code, which, I believe, PBR do. That's not to say that the many tax issues for PBR will go away once we conclude that PBR are CRVM reserves; I just believe that, if the NAIC labels PBR as CRVM reserves, Section 807(d) literally provides that that is the tax reserve method.

Where do you stand, Ed?

**Ed:** I am closer to category three. I do not dismiss the possibility that the stochastic reserves will be considered part of CRVM reserves for tax purposes, but, I believe, that, at a minimum, the deterministic reserves, in fact, do exhibit characteristics of a CRVM reserve as it was understood in 1984.

**Peter:** I agree. But, some have suggested that the gross premium valuation method of PBR cannot be considered similar to CRVM because CRVM is based on a net premium approach However, I believe that the net premium approach of CRVM indirectly considers expenses in its amortization of an expense allowance. Isn't the direct treatment of expenses in the gross premium valuation (GPV) approach under PBR somewhat comparable to the indirect treatment of expenses in current CRVM?

I believe that Congress delegated to the NAIC the determination of the proper tax reserve method as long as the reserves otherwise satisfy the definition of life insurance reserves in Section 816(b) of the Internal Revenue Code. ....

**Ed:** It can be. But first I would like to point out that the GPV, subject to certain constraints, can be considered a "net premium approach," depending on how you define "net premium approach," and contradictory though that might appear. The GPV is essentially the present value of future benefits and expenses, minus the present value of future gross premiums. Assumptions are current and include margins on certain assumptions to produce "prudent best estimates."[2] Company-specific mortality experience is planned to be mapped to a table in the set of NAIC prescribed tables differentiated by risk class. Interest, lapsation, premium attrition and expenses are currently intended to be company-specific.

Let us assume for purposes of this discussion that the margins will be exactly sufficient at the issue date of the policy to produce a zero GPV at the issue date (also assuming that the assumptions without margins result in a profitable product)[3] Put differently, the margins are sufficient so that zero future profits at issue are assumed. Thus, the gross premiums can be parsed into benefit premiums (BPs) and expense premiums (EPs), each a level percent of gross premiums, and such that the gross premium at any duration equals BP + EP at that duration.

continued ⋙ 6

[2] This article uses the term "prudent best estimate" while it is recognized that that language is currently coming under question.

[3] Assumption of zero future profits at the issue date was one alternative approach mentioned in the Life Reserve Working Group discussions

The GPV for any policy can also be viewed as a sum of two components, i.e.:

(i) Present value of future benefits, minus present value of future BPs plus

(ii) Present value of future expenses, minus present value of future EPs.

For a traditional, fixed premium policy, the benefit reserve (reserve (i), above) is a net level reserve, while the expense reserve (reserve (ii), above) is generally a negative amount, due to heavy initial acquisition expenses.

The CRVM, as defined in the Standard Valuation Law (SVL), can actually be shown to result in a net level reserve (for benefits, using mortality and interest and perhaps lapses), minus the unamortized CRVM allowance. Thus, the GPV benefit [net level] reserve is analogous to the CRVM net level reserve, while the GPV expense reserve is analogous to the unamortized CRVM allowance. I will include another analysis for *Taxing Times* that demonstrates the strong relationship of a GPV so calculated[4] to a CRVM reserve. Take a look at this illustration of the CRVM under some simplistic assumptions

We can now parse the CRVM reserve into a net level benefit reserve and an unamortized CRVM allowance To wit on page 7.

Now in this second table you can see that the CRVM reserve can be split into its benefit assumption component (col.1) and expense assumption component (col.2). If we then take a look at the GPV structure, as modified to produce zero future profits at issue, and we split it into:

- Present value of benefits minus present value of benefit premiums, and

- Present value of expenses minus present value of expense premiums,

5-Year Term Policy:
Assumptions: Zero interest
No lapses or other terminations over the 5 years

| Anniversary | Claim Cost | Present Value of Claims | CRVM Allowance | (2) Present Value of Expenses | Valuation Premium (VP) | (3) Present Value of VP's | (4) CRVM Reserve =(1)+(2)-(3) |
|---|---|---|---|---|---|---|---|
| At issue (0) | N/A | 30 00 | | 4 00 | | 34 00 | - |
| 1 | 2.00 | 28 00 | 4 00 | - | 6 80 | 27 20 | 0.80 |
| 2 | 3.00 | 25 00 | - | - | 6 80 | 20 40 | 4.60 |
| 3 | 5.00 | 20 00 | - | - | 6 80 | 13.60 | 6 40 |
| 4 | 8 00 | 12.00 | - | - | 6 80 | 6.80 | 5 20 |
| 5 | 12 00 | - | - | - | 6 80 | - | - |

**VP calculation**

| | Pres.Value | Annual | |
|---|---|---|---|
| Benefits | 30 00 | 6.00 | (Benefit Premium) |
| CRVM Allowance | 4.00 | 0.80 | (CRVM Premium) |
| Total Costs | 34.00 | 6.80 | (Total VP) |

[4] Another constraint on the GPV that would build a yet stronger equivalence to the CRVM would be that renewal expenses are assumed to be a level percentage of gross premiums

| Anniversary | Present Value of Claims | Present Value of BP's) | (1) Benefit Reserve | Present Value of Expenses | Present Value of CP's | (2) Unamortized CRVM Allowance | (3) CRVM Reserve =(1)+(2) |
|---|---|---|---|---|---|---|---|
| At issue (0) | 30.00 | 30.00 | - | 4.00 | 4.00 | - | - |
| 1 | 28.00 | 24.00 | 4.00 | - | 3.20 | (3.20) | 0.80 |
| 2 | 25.00 | 18.00 | 7.00 | - | 2.40 | (2.40) | 4.60 |
| 3 | 20.00 | 12.00 | 8.00 | - | 1.60 | (1.60) | 6.40 |
| 4 | 12.00 | 6.00 | 6.00 | - | 0.80 | (0.80) | 5.20 |
| 5 | - | - | - | - | - | | |

| Anniversary | Present Value of Claims | Present Value of BP's) | (1) Benefit Reserve | Present Value of Expenses | Present Value of CP's | (2) Unamortized CRVM Allowance | (3) CRVM Reserve =(1)+(2) |
|---|---|---|---|---|---|---|---|
| At issue (0) | 30.00 | 30.00 | - | 4.00 | 4.00 | - | - |
| 1 | 28.00 | 24.00 | 4.00 | - | 3.20 | (3.20) | 0.80 |
| 2 | 25.00 | 18.00 | 7.00 | - | 2.40 | (2.40) | 4.60 |
| 3 | 20.00 | 12.00 | 8.00 | - | 1.60 | (1.60) | 6.40 |
| 4 | 12.00 | 6.00 | 6.00 | - | 0.80 | (0.80) | 5.20 |
| 5 | - | - | - | - | - | | |

we then have a strong similarity to the CRVM structure as defined in the SVL. Obviously, the values can be very different, but the structure has significant similarities.

Interestingly, in the expense column in the first table, if the renewal expense were a positive level number, and the first year expense were $4 higher than the level renewal expense, we would still get the same CRVM reserve. The reason is that the increased costs each year would be exactly matched by the increase in gross premiums. Moreover, the CRVM allowance would still be $4 and a positive loading (gross premium minus net premium) would be in effect in each renewal year, equal to the level renewal expense. That fact pattern would certainly appear to be consistent with a "net premium method."

**Ed:** Peter, even though I have shown that PBR and CRVM are conceptually comparable, I have heard you say that it may not really matter if PBR are labeled CRVM for them to qualify as the tax reserve method for tax purposes. Please explain what you mean by this.

**Peter:** You heard me correctly. As I mentioned earlier, CRVM only applies for tax reserves if the NAIC prescribes CRVM for the contract at the time the contract is issued. Section 807(d) goes on to say that, if no CRVM has been prescribed by the NAIC, the reserve method prescribed by the NAIC will still govern. So, PBR should be the tax reserve method for contracts issued after the NAIC adopts PBR whether or not they are labeled CRVM.

**Ed:** Putting your tax lawyer hat on, what is your preference—do you believe it is better for PBR to be labeled CRVM by the NAIC or something else?

**Peter:** I believe it may be better not to label PBR as CRVM. Let's assume that you and I are wrong and the first school of thought we talked about earlier prevails or is adopted by the IRS. That is, let's assume it is ultimately determined that PBR are labeled CRVM, but they do not qualify as CRVM reserves for tax purposes because they are too much of a departure from CRVM as it was contemplated by Congress in 1984. The tax result in this situation is unclear. Under the rule in Section 807(d) that I previously mentioned, if no reserve method has been prescribed by the NAIC for the contract, then a reserve method consistent with CRVM must be applied. But, the problem would be that there is no longer a CRVM as contemplated by Congress prescribed by the NAIC. To solve this problem, it may make sense for PBR *not* to be labeled CRVM, and instead, for the NAIC to keep the current CRVM in place for contracts issued prior to the adoption of PBR and for contracts to which PBR do not apply. This way, it will be clear, first, that PBR are not really CRVM reserves, but they qualify as the tax reserve method in their own right as an entirely new reserve method prescribed by the NAIC. Second, if this position does not prevail, there will still be a CRVM prescribed by the NAIC which would qualify as the default tax reserve method.

**Ed:** This still leaves open the concern expressed by some that, by and large, stochastically generated reserves are not generated on a contract-by-contract basis, which makes it difficult if not impossible to apply the comparison of such a reserve with the statutory reserve at the contract level, pursuant to Section 807(d). Can you speak to this issue?

**Peter:** I do not agree that the contract-by-contract comparison required for tax purposes would be difficult or impossible. Remember, the primary purpose of the reserves in the first place is to permit regulators to ensure that the reserves are adequately backed up by assets so that an insolvency does not occur. In the event of insolvency, a shortfall in assets of the company typically are allocated to policyholders in proportion to

continued → 8

⏭ Actuary/Tax Attorney Dialogue on Selected Tax Issues … from pg. 7

statutory reserves. Therefore, to provide guidance in the event of insolvency, it should be important to the regulators that the final version of PBR specify a methodology for allocating the stochastic reserve to individual contracts. It is my understanding the current version of PBR does just that. I do not see any reason why the method of contract-by-contract allocation chosen by the NAIC will not be accepted for tax purposes. After all, it will have independent economic significance and will not be subject to manipulation if it is set forth explicitly in the NAIC guidance.

**Ed:** As you're aware, Peter, practitioners differ on this contract-by-contract issue.

**Peter:** I'm aware of that

**Ed:** Switching subjects slightly, can you explain why a migration to PBR would still require us to keep our old CRVM software?

**Peter:** Yes, but you will have to do that anyway because tax reserves for contracts issued before the NAIC adopts PBR will still have to be computed using the old CRVM

**Ed:** Can you explain why?

**Peter:** Section 807(d) says that the tax reserve method is the method in effect on the date of issuance of the contract As a result, PBR will not apply retroactively for tax purposes, even if it is retroactive for statutory purposes. The old CRVM software will still have to be used for a long time in any event.

**Ed:** Peter, you and I have discussed a potential tax issue that may arise from PBR taking into account future expense liabilities. Can you explain the issue?

**Peter:** When we talk about the tax reserve method, we are referring to the tax deduction for life insurance reserves. Life insurance reserves are defined in Section 816(b) of the Code to refer to amounts which are set aside to mature or liquidate future unaccrued claims arising under the insurance or annuity contracts. Future expenses are not claims arising under the contract and, in general, expenses are deductible by life insurance companies on an accrual basis, not a reserve basis. So, the tax issue is: how do we demonstrate that PBR are not, in part, reserves for future nondeductible unaccrued expenses? In general, I think that it may be necessary to show that the future expenses taken into account in PBR do not exceed the future revenue stream attributable to those expenses. That is, we need a demonstration that shows that including expenses in the PBR calculation actually decreases reserves; or, if expenses increase reserves, we need to know by how much so that any deduction disallowance is limited to the portion of the reserve that is actually held for future unaccrued expenses. Ed, I think that in your earlier examples you referred to this topic. Can you take it from here?

**Ed:** Yes, the issue is strongly related to our earlier discussion that demonstrated the structural equivalence of the PBR deterministic reserves to CRVM reserves. As we discussed earlier, the GPV can then be defined as the net algebraic sum of the following two components at any valuation date:

(i) Present value of benefits minus present value of benefit premiums, and

(ii) Present value of expenses minus present value of expense premiums. These two items would be computed, and perhaps disclosed officially, perhaps in the statutory annual statement. If (ii) is positive, that amount of the GPV would be disallowed Conversely, if it is negative, there would be no disallowance.

Just to wrap up, I'd like to make two points. First, as you can see, experienced tax practitioners are not unanimous in their opinions on the issues. Second, the issues we have discussed today are not the only issues There are several other major issues of concern to the tax practitioners that would affect deductibility. There is the additional issue of defining principles-based tax *accounting* on the statutory statement. Finally—and perhaps the most important issue—to our knowledge, no detailed post-tax modeling has been performed, so that the post-tax financial effect of PBR is still an unknown.

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## Employee Benefits
MEETING

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**This program**, jointly sponsored by the SOA and CCA, will deliver a robust and diverse curriculum with a unique series of sessions and embedded seminars on significant topics of critical importance to employee benefits actuaries.

# More on Reasonable Mortality: IRS Issues Notice 2006-95

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

Last October, the Internal Revenue Service (IRS) released Notice 2006-95, 2006-45 I.R.B. 848, which interprets the reasonable mortality charge requirement of Section 7702(c)(3)(B)(i).[1] According to its terms, the new notice "supplements" Notice 88-128, 1988-2 C.B. 540, and "modifies and supersedes" Notice 2004-61, 2004-2 C.B. 596. (An article on Notice 2004-61 appeared in the March 2005 issue of *Taxing Times*.) Under Section 7702(c)(3)(B)(i), the determination of a life insurance contract's guideline premiums and net single premiums must be based on "reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued." This same mortality charge requirement applies for purposes of the 7-pay test under Section 7702A, which defines a "modified endowment contract" for federal tax purposes.

Notice 2006-95 observes that the 2001 CSO tables became the prevailing commissioners' standard tables within the meaning of Section 807(d)(5) during calendar year 2004, and that such tables have now been adopted by all 50 states. To address the change in the prevailing tables, the IRS issued Notice 2004-61, which expanded upon the safe harbors originally provided in Notice 88-128 regarding mortality charges that would be considered reasonable. Notice 2004-61 requested comments on the need for additional guidance with respect to the transition to the 2001 CSO tables, and Notice 2006-95 states that it was issued in response to comments that were received.

Notice 2006-95 states that neither it nor Notices 88-128 and 2004-61 address the reasonable mortality charge requirement in the case of substandard risks. Thus, reasonable mortality charges for contracts with substandard mortality rate guarantees generally will continue to be governed by the interim rule of section 5011(c)(2) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647. Under this rule, a life insurance contract issued before the effective date of temporary or final regulations will be deemed to satisfy the reasonable mortality charge requirement of Section 7702(c)(3)(B)(i) if the mortality charges assumed in section 7702 calculations "do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristic of the insured of which the company is aware)."

**Safe Harbors.** Notice 2006-95 provides three safe harbors with respect to the reasonable mortality charge requirement of Section 7702(c)(3)(B)(i) that are similar, but not identical, to those of Notice 2004-61:

- The first safe harbor, set forth in section 4.01 of Notice 2006-95, provides that the interim rules described in Notice 88-128 remain in effect "except as otherwise modified by the notice." Notice 88-128 included an interim rule allowing use of mortality charges that do not exceed 100 percent of the applicable mortality charges set forth in the 1980 CSO tables. One modification to the interim rules of Notice 88-128 made by Notice 2006-95 (and previously by Notice 2004-61) results from the change in the prevailing mortality table to 2001 CSO in 2004. Reflecting this change, and taking account of the transition rules of the NAIC model regulation implementing the

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

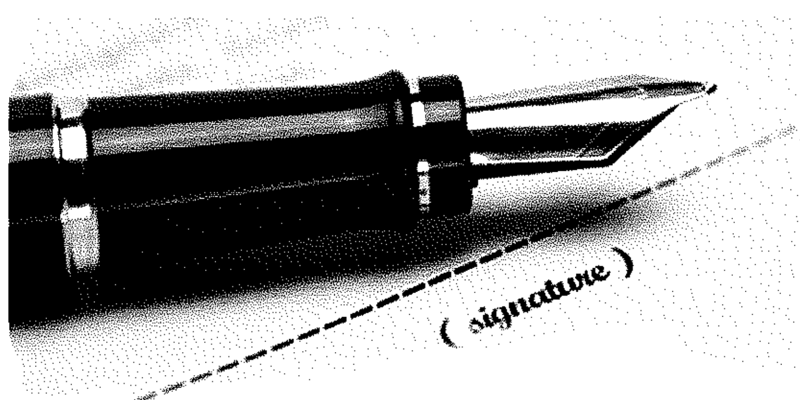
new tables, Section 2 of Notice 2006-95 observes: "The 1980 CSO tables may still be used in all states for contracts issued in calendar years through 2008. For contracts issued after 2008, use of the 2001 CSO tables will be mandatory." Notice 2004-61 contained a similar statement applicable for contracts issued in states that had adopted the 2001 CSO tables; Notice 2006-95 observes that all states have now adopted the 2001 CSO tables

- The second safe harbor, set forth in Section 4.02 of Notice 2006-95, provides that a mortality charge with respect to a life insurance contract will satisfy the requirements of Section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables; (2) the contract is issued in a state that permits or requires the use of the 1980 CSO tables at the time the contract is issued; and (3) the contract is issued before Jan. 1, 2009. It is unclear what situations might satisfy this second safe harbor which would not satisfy the first safe harbor described above. It may be that this safe harbor simply represents a restatement of the second safe harbor of Notice 2004-61 with a modification—an important one—that removes a requirement added by Notice 2004-61 that the mortality charges assumed in the Section 7702 calculations cannot exceed the mortality charges specified in the contract at issuance. Section 3 of the new notice expressly states that this change was made to ensure that it does not subject 1980 CSO contracts to more stringent standards, retroactively, than applied under Notice 88–128. Since the first safe harbor of Notice 2004-61—permitting continued use of the interim rules of Notice 88-128—was never subject to the requirement limiting the mortality charges assumed to those specified in the contract at issuance, this is a welcome clarification It may also be that this second safe harbor of the new notice was intended to implement the "sunset" statement, made in Section 2 thereof, that for contracts issued after 2008, use of the 1980 CSO tables will no longer be allowed.

- The third safe harbor, set forth in Section 4.03 of Notice 2006-95, provides that a mortality charge with respect to a life insurance contract will satisfy the requirements of Section 7702(c)(3)(B)(i) so long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after Dec. 31, 2008, or (b) the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO tables at the time the contract is issued As insurers design products with the intention of complying with this safe harbor, special care should be paid to ensuring that the contract does not in some way guarantee mortality charges less than charges based on 100 percent of 2001 CSO, such as through a secondary guarantee contained in the contract. If there were a more liberal mortality rate guarantee, it would be necessary to reflect it in the calculations under Section 7702 in order to come within the ambit of this safe harbor

**The Importance of Meeting One of the Safe Harbors.** The reasonable mortality charge requirement, apart from guidance such as Notice 2006-95 and its predecessors, is tied to the prevailing commissioners' standard tables as defined in Section 807(d)(5). Since the 2001 CSO tables became "prevailing" during 2004, the mortality tables' "year of change" within the meaning of the Section 807(d)(5)(B) transition rule was 2005, so that under that rule—barring other guidance—the 1980 CSO tables would continue to be permitted to be used as the prevailing tables for "the 3-year period beginning with the first day of the year change," i.e., only through Dec. 31, 2007. Thus, looking soley at the statutory rules, use of the 2001 CSO tables would be required for contracts covering standard risk insureds issued after Dec 31, 2007. Thus, it appears critical that 1980 CSO contracts meet a safe

continued 12



from pg. 11

harbor if they are issued during 2008, since it may not otherwise be possible for such designs to comply with the statute.

**Rules for Smoker- and Gender-Based Tables.** Notice 2004-61 had expressly permitted the use of gender- and smoker-based mortality tables, but only if a consistency requirement was met. In particular, if a state permitted the use of 1980 CSO or 2001 CSO unisex tables in determining minimum nonforfeiture values, Notice 2004-61 allowed such tables to be used for female insureds provided the same tables were used for male insureds. Similarly, if a state permitted the use of 1980 CSO or 2001 CSO smoker and non-smoker tables in determining minimum nonforfeiture values, Notice 2004-61 allowed such tables to be used for smoker insureds provided nonsmoker tables were used for nonsmokers. Notice 2006-95 retains these rules, but only for purposes of the 2001 CSO tables under the notice's third safe harbor.

Section 3 of Notice 2006-95 describes this change as intended to help ensure that Notice 2006-95 does not subject 1980 CSO contracts to more stringent standards, retroactively, than applied under Notice 88-128. Apparently, the express consistency requirement applicable under Notice 2004-61 for the use of gender- and smoker-based tables was considered to be a restriction potentially being applied retroactively. Proposed Reg. Section 1.7702-1, for example, had included a similar consistency requirement with respect to permissible mortality assumptions, but such regulations were never finalized. Thus, Notice 2006-95 clarifies that mortality charges deemed reasonable under the safe harbors of Notice 88-128 continue to be considered reasonable without regard to the consistency rule of Notice 2004-61. This particular change made by Notice 2006-95 does not appear intended to broaden the scope of the Notice 88-128 safe harbors, but rather to ensure that they are not curtailed.

One question that has arisen from the changes made by Notice 2006-95 relates to the Notice 88-128 safe harbor rule permitting use of 1980 CSO unisex tables under Section 7702 if the state requires use of such tables. Prior to Notice 2004-61, the use of unisex tables in states that permitted, but did not require, the use of such tables seemingly was not encompassed by the Notice 88-128 safe harbor. (This did not mean that this practice ran afoul of the reasonable mortality charge requirement, but rather simply that the safe harbor was unavailable to confirm compliance with the requirement.) One beneficial consequence of Notice 2004-61 was that it confirmed that such permissive uses of unisex 1980 CSO tables were proper in circumstances where unisex tables were consistently used. The modification of Notice 2004-61 by Notice 2006-95 gives the appearance that such safe harbor treatment is now being withdrawn. In view of the rationale set forth in Notice 2006-95 for this change, such a result seems unintended. Similar considerations may apply as well with respect to the change relating to the use of smoker-distinct 1980 CSO tables.

Thus, Notice 2006-95 clarifies that mortality charges deemed reasonable under the safe harbors of Notice 88-128 continue to be considered reasonable without regard to the consistency rule of Notice 2004-61.

**Issue Date of Contracts.** As noted above, Notice 2006-95 states that "for contracts issued after 2008, use of the 2001 CSO tables will be mandatory." Similar to Notice 2004-61, the new notice states that for purposes of applying it, "the date on which a contract was issued generally is to be determined according to the standards that applied for purposes of the original effective date of § 7702. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1076 (1984), 1984-3 (Vol. 2) C.B. 330; see also 1 Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, at 579 (Comm. Print 1984)." Also similar to Notice 2004-61, Notice 2006-95 then observes, as an example, that contracts received in exchange for existing contracts are to be considered new contracts issued on the date of the exchange. After this, Notice 2006-95 states as a general rule that a change in an existing contract will not be

considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract and mortality and expense charges) are the same as the terms of the contract prior to the change.

Notice 2006-95 goes on to provide guidance regarding changes that, even though material, also will not cause a contract to be newly issued for purposes of applying the reasonable mortality charge requirement. In particular, Section 5.02 of Notice 2006-95 states that:

> "[I]f a life insurance contract satisfied [the first or second safe harbor of the notice] when originally issued, a change from previous tables to the 2001 CSO tables is not required if (1) the change, modification, or exercise of a right to modify, add or delete benefits is pursuant to the terms of the contract; (2) the state in which the contract is issued does not require use of the 2001 CSO tables for that contract under its standard valuation and minimum nonforfeiture laws; and (3) the contract continues upon the same policy form or blank."

Notice 2006-95 further states, in Section 5.03, that:

> "The changes, modifications, or exercises of contractual provisions referred to in section 5.02 include (1) the addition or removal of a rider; (2) the addition or removal of a qualified additional benefit (QAB); (3) an increase or decrease in death benefit (whether or not the change is underwritten); (4) a change in death benefit option (such as a change from an option 1 to option 2 contract or vice versa); (5) reinstatement of a policy within 90 days after its lapse; and (6) reconsideration of ratings based on rated condition, lifestyle or activity (such as a change from smoker to nonsmoker status)."

In describing the changes being made to the rules of Notice 2004-61 with respect to the identification of the issue date of a contract, Notice 2006-95 provides three comments:

- First, the Notice states that "the rule for determining the issue date of a contract that undergoes an increase or decrease in death benefit is simplified by eliminating the concept of 'underwriting.' This change broadens the grandfather rule of Notice 2004-61 to encompass many routine transactions, but does not wholly defer to an issuer's administrative practices and procedures."
- Second, the Notice states that "additional examples are provided of changes, modifications, or exercises of contractual provisions that will not require a change from previous tables to the 2001 CSO tables."
- Third, the Notice states that "[e]xcept as described above, this notice does not modify the definition of 'issue date' that was provided in Notice 2004-61."

Sections 5.02 and 5.03 of Notice 2006-95 provide very welcome guidance. One issue that has long existed, for example, regards the situation in which a contract's death benefit may be increased, with or without underwriting, in exercise of rights contained in the contract. Given the prevalence of universal life insurance and other flexible premium contracts in the market, such changes often are common—or "routine," to use the language of the Notice. This being said, if such changes in benefits cause a contract to be considered newly issued and subject to a different reasonable mortality charge requirement due to a change in the prevailing tables, in many cases the contract would not be able to continue to comply with Section 7702 without substantial alteration of the material terms of the contract (which neither party to the contract would have contemplated at issue, even though flexibility with respect to benefits was contemplated). The guidance of Notice 2006-95 recognizes this concern and generally confirms

continued ≫14

More on Reasonable Mortality …
from pg 13

that these routine transactions will not result in a loss of grandfathering.

Some questions have been raised regarding how the above rules should be applied. One question, for example, regards the relationship between Section 5.02 and Section 5.03 of Notice 2006-95. In this regard, when events (such as the addition of a QAB) are identified in Section 5.03 as "changes, modifications, or exercises of contractual provisions referred to in Section 5.02," does this mean that such events should be considered as satisfying the requirements of section 5.02? Alternatively, is it necessary for a right to exist in the contract that is being exercised in order for the continued grandfather treatment provided under Section 5.02 to apply, *i.e.*, is Section 5.03 merely confirming that certain types of changes will be encompassed by Section 5.02 *if* a right exists with respect to the change? This alternative interpretation could be problematic, since some of the changes described in Section 5.03, such as additions of QABs, often are not expressly guaranteed under contracts.

Another question regards the requirement under Section 5.02 limiting the applicability of this provision to situations where a contract met the safe harbor of Section 4.01 or 4.02 (*i.e.*, the two 1980 CSO safe harbors) when issued. If neither of these safe harbors has been met but the contract nonetheless satisfies the reasonable mortality charge requirements when issued, what is the effect of a change to the contract that is pursuant to a right set forth in the contract, *e.g.*, an increase in benefits that may or may not have been underwritten? A further question relates to the reference to reinstatements within 90 days of lapse. If a right to reinstate applies under a contract for a longer period (which typically is the case), should reinstatements beyond the 90-day period result in a loss of grandfathered status? In this latter case, it would seem that the general rule of Section 5.02 would apply, and the fact that a reinstatement is not specifically identified in the list of examples in Section 5.03 should not alter this result.

A final question regards the meaning of the statement made in Notice 2006-95 explaining the deletion of the reference to "underwriting." The new notice observes that "[t]his change broadens the grandfather rule of Notice 2004-61 to encompass many routine transactions, but does not wholly defer to an issuer's administrative practices and procedures." From this statement, it appears that underwritten benefit increases pursuant to a right in a contract, while *generally* not causing a loss of grandfathering, may in some circumstances have that consequence. Given that a purpose of this change is to protect "routine transactions," it may be that the protections of Sections 5.02 and 5.03 might not apply in the case of some extraordinary changes, although on their face these rules contain no such limitation.

**Effective date.** Notice 2006-95 is effective Oct. 12, 2006. The Notice states, however, that its provisions will not be applied adversely to taxpayers who issued, changed or modified contracts in compliance with Notice 2004-61 (without regard to the modifications to Notice 2004-61 made by Notice 2006-95)

**Final thoughts.** Many of the rules provided by Notice 2006-95 have been favorably received by insurers. This is particularly true with respect to the revisions made to Notice 2004-61 regarding a contract's issue date for purposes of applying the safe harbors. Such changes were appropriate given that, while modern life insurance policies often offer flexibility with respect to benefits, much less flexibility may apply with respect to the mortality basis underlying a contract's guarantees. The reality is that loss of grandfathered status presents a host of difficulties—both legal and practical—for insurers, and thus it is proper to apply the reasonable mortality charge requirement in a manner that protects the expectations of the parties when contracts are issued, including, for example, that numerous common changes may be made in the future without either the insurer or the policyholder being subjected to new mortality guarantees either contractually or in applying Section 7702 (and Section 7702A). Notice 2006-95 appropriately reflects this concern. Moreover, both Notice 2004-61 and Notice 2006-95 have provided guidance on a timely basis, so that the transition to the 2001 CSO tables can be more readily and thoughtfully pursued by insurers. ◀

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# New "Best Practices" Rules for Corporate-Owned Life Insurance

*by John T Adney and Bryan W. Keene*

Last summer, President Bush signed into law the Pension Protection Act of 2006 (the Act), which included new rules governing the federal income tax treatment of corporate-owned life insurance (COLI) contracts that employers purchase on the lives of their employees These new rules, also known as "COLI best practices," are aimed at curtailing certain perceived abuses that were described in several negative press stories as involving the use of COLI to insure low-level employees without their knowledge or consent In response to these concerns, the new rules deny the normal exclusion from income for death benefits under COLI contracts that insure the lives of rank-and-file employees and for any COLI contracts with respect to which new notice and consent requirements are not met This article briefly summarizes the new rules and describes certain issues that employers, life insurers, and insurance brokers may face when implementing them.

## Taxable Death Benefits as the General Rule

The COLI best practices rules are set forth in new section 101(j) of the Internal Revenue Code.[1] The new rules deny the exclusion from income under Section 101(a)(1) for death benefits under an "employer-owned" life insurance contract.[2] An employer-owned life insurance contract is defined as a life insurance contract that (1) is owned by a trade or business, (2) directly or indirectly benefits that trade or business (or a related party), and (3) covers the life of an "insured" who is an "employee" with respect to the trade or business of the "applicable policyholder" on the date the contract is issued.[3]

The term "employee" generally is understood to include all individuals who are considered employees under common law principles, but the term also is defined specifically to include officers and directors as well as highly compensated employees within the meaning of section 414(q) (discussed in more detail below).[4] The term "insured" refers only to United States citizens or residents, and includes both insureds under a joint life policy.[5]

"Applicable policyholder" generally means the person described in (1) and (2) above (the owner), but also includes related persons described in section 267(b) or 707(b)(1) and any person that is engaged in trades or

continued »16

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

[2] Death benefits remain excludable to the extent they do not exceed the premiums and other amounts that the owner paid for the contract, *i.e.*, as a recovery of the investment in the contract

[3] Section 101(j)(3)(A) For this purpose, coverage for each insured under a master group contract is treated as a separate contract to which the new COLI best practices rules apply if such coverage is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A.

[4] Section 101(j)(5)(A)

[5] Section 101(j)(5)(B).

New "Best Practices" Rules ...
from pg. 15

businesses with the owner that are under common control within the meaning of section 52(a) or (b).[6] Section 267(b) describes a number of relationships that could be relevant to the typical COLI purchaser, including corporations that are members of the same controlled group; fiduciaries, grantors, and beneficiaries of trusts; and corporations and partnerships with certain overlapping ownership interests. Section 707(b) describes similar relationships in the context of partnerships, while sections 52(a) and (b) set forth definitions for "controlled group[s] of corporations" and similar rules for other trades and businesses, respectively. All of these cross-references to existing rules for affiliated entities are intended to establish a broad and sweeping definition of an "applicable policyholder" to which the new COLI best practices rules apply.

## Exceptions to the General Rule for "Key Person" Coverage

The new COLI best practices rules include several important exceptions to the general exclusion disallowance rule described earlier. The most relevant of these exceptions for the broad-based COLI market involve contracts that insure the lives of key employees. Specifically, COLI death benefits will retain their tax-free character to the extent that they are paid under a contract insuring the life of an individual who is, at the time the contract is issued, a (1) director, (2) highly compensated employee, or (3) highly compensated individual with respect to the applicable policyholder.[7]

For purposes of the foregoing exception, the COLI best practices rules cross-reference section 414(q) in defining "highly compensated employee" and cross-reference section 105(h)(5) in defining "highly compensated individual."[8] These Code provisions address nondiscrimination testing in tax-qualified retirement plans and self-funded employer health plans, respectively. Section 414(q) defines a highly compensated employee as any employee who (1) was a five percent owner at any time during the year or the preceding year,[9] or (2) had compensation from the employer in excess of $100,000 (indexed for inflation) for the preceding year. Section 105(h)(5) defines a highly compensated individual as an individual who is (1) one of the five highest paid officers, (2) a shareholder who owns (or constructively owns under section 318) more than 10 percent in value of the stock of the employer, or (3) among the highest paid 35 percent of all employees.[10] A number of questions, discussed next, could arise as taxpayers attempt to implement the key person exception to the general exclusion disallowance rule described above.

[6] Section 101(j)(3)(B).

[7] Section 101(j)(2)(A)(ii). Exceptions to the general exclusion disallowance rule also apply in the case of (1) any contract covering the life of an insured who was an employee of the owner within the 12 month period prior to the insured's death, and (2) any contract under which the death benefits are payable to the insured's beneficiaries (other than the applicable policyholder), or are used by the applicable policyholder to purchase an equity interest in the business from the insured's heirs. Section 101(j)(2)(A)(i) and (B).

[8] Section 101(j)(2)(A)(ii)(II). The cross-reference to section 414(q) is without regard to paragraph (1)(B)(ii) thereof.

[9] A 5-percent owner is defined in section 416(i)(1)(B)(i).

[10] Technically, section 105(h)(5) defines highly compensated individual to include only the highest paid 25 percent of employees, but the Act increased that percentage to 35 percent for purposes of the COLI best practices rules.

### Aggregating Affiliated Businesses

The key person exception is available only if the contract covers an individual who is a director, highly compensated employee, or highly compensated individual "with respect to [the] applicable policyholder." As indicated above, the term "applicable policyholder" is defined broadly to include persons who share certain affiliations with the entity that actually owns the contract or who are engaged in commonly controlled trades or businesses with the owner. As a result of this definition, it would appear that the determination of whether an insured is a highly compensated employee or highly compensated individual for purposes of the COLI best practices rules must be made by looking to all employees of the affiliated group, not just the entity that is named as owner of the contract.

For purposes of Section 414(q), which defines "highly compensated employee" to include a five percent owner, this would appear to narrow the scope of individuals who can be insured by requiring that an employee be a five percent owner of the affiliated group, rather than a five percent owner of any particular entity within the affiliated group. For purposes of Section 105(h)(5), which defines highly compensated individual to include an individual who is among the highest paid 35 percent of all employees, this would appear to broaden the scope of individuals who can be insured by applying the 35 percent standard to a larger pool of potential insureds (*i.e.*, all those within the affiliated group).

In all events, employers will need to take care in identifying which individuals can be insured. For example, an individual who is one of the highest paid 35 percent of employees of a particular entity within the affiliated group might not be one of the highest paid 35 percent on an affiliated group basis. To the extent this possibility results in a contract issued to Affiliate X insuring the lives of employees of Affiliate Y, additional questions could arise under applicable insurable interest laws and the interest expense disallowance rules of Section 264(f). Finally, the aggregation rules could give rise to some practical implementation issues, such as where obtaining compensation information for all members of the affiliated group is difficult.

### Determining "Compensation"

The "highly compensated" exceptions described above require a determination of a potential insured's compensation level, which for purposes of Sections 414(q) and 105(h) generally is determined under Section 415(c)(3). The regulations under that section include safe harbor definitions of compensation that employers may wish to use when implementing the COLI best practices rules. Thus, taxpayers will need to become familiar with those rules as they may affect their COLI transactions. For example, the regulatory safe harbors do not cover some types of remuneration, such as non-taxable grants of equity interests in the employer's business, which would be taken into account only at the time that the equity grants become subject to income tax (*e.g.*, at the time a stock option is exercised)

### Excluding Certain Employees

Section 105(h)(3)(B) permits certain categories of employees to be disregarded for purposes of nondiscrimination testing. One question that might arise is whether these exclusions are permissive or mandatory in the context of the COLI best practices rules, as they generally would result in fewer employees who could be insured.[11] Another question is whether a provision

continued >>18

[11] *See* STAFF OF THE J. COMM. ON TAX'N, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, at 211, n. 233 (J. Comm. Print 2006) ("2006 Technical Explanation") (stating that "[a]s under present law, certain employees are disregarded in making the determinations regarding the top-paid groups."). Similar statutory exclusions of employees are available under section 414(q)(5), but those exclusions would appear to be irrelevant for purposes of the COLI best practices rules because the Act does not incorporate the provision under section 414(q)(5) under which those exclusions apply.

in Section 105(h) that prohibits the exclusion of an employee who participates in certain types of health plans carries over to the COLI best practices rules so that such employees must always be counted when determining the top-paid group

### Considering Former Employees

In some cases, a former employee is considered to be a highly compensated employee for purposes of nondiscrimination testing of tax-qualified retirement plans.[12] However, individuals who are former employees at the time a COLI contract is issued may not be able to be insured in accordance with the COLI best practices rules

**Finally, the aggregation rules could give rise to some practical implementation issues, such as where obtaining compensation information for all members of the affiliated group is difficult.**

due to the requirement that an employee be highly compensated "at the time the contract is issued." In addition, insuring former employees could give rise to serious questions under state insurable interest laws, as well as adverse tax consequences under the rules of section 264(f), which deny interest deductions in such contexts

### Year of Determination

Sections 414(q) and 105(h) base their determinations of highly compensated status on an employee's compensation for the preceding year and the current year, respectively. These timing rules could present questions when implementing the COLI best practices rules in cases involving new and mid-year hires.

### Notice and Consent Requirements

The COLI best practices rules also impose new notice and consent requirements with respect to all employer-owned life insurance contracts. If these requirements are not met prior to the issuance of any employer-owned life insurance contract, the death benefits paid under that contract will be taxable, irrespective of whether an exception to the general exclusion disallowance rule otherwise might be available (e.g., even if the contract insures only key persons). Under the notice and consent requirements, the employee must (1) be notified in writing that the employer intends to purchase the coverage and such notification must disclose the "maximum face amount for which the employee could be insured at the time the contract was issued," (2) provide written consent to the coverage and that it may continue after the insured's employment is terminated, and (3) be informed in writing that the death benefits will be payable to the employer.[13] A number of questions, discussed next, could arise as taxpayers attempt to implement the notice and consent requirements of the COLI best practices rules.

### Industry Practices Regarding Insurance Binders

Traditionally, large COLI purchases are accomplished using a binding premium receipt, which provides immediate coverage in a specified amount for a stipulated time period, such as until the insurance company completes the underwriting process or until the purchaser obtains any insured consents required by state insurance law. At or before the end of the stipulated time period, a formal life insurance contract is issued and the insurer typically will backdate the effective date of coverage under the formal contract to coincide with the date that the binder was provided. This practice has not been known to present federal income tax problems in the past. However, it could result in a failure to satisfy the new notice and consent requirements to the

[12] Section 414(q)(6)

[13] Section 101(j)(2)(A)(ii) Exceptions to the general exclusion disallowance rule also apply in the case of (1) any contract covering the life of an insured who was an employee of the owner within the 12 month period prior to the insured's death, and (2) any contract under which the death benefits are payable to the insured's beneficiaries (other than the applicable policyholder), or are used by the applicable policyholder to purchase an equity interest in the business from the insured's heirs. Section 101(j)(2)(A)(i) and (B)

extent that it results in contracts being issued (and insurance being in force) prior to the date that all consents required by the Act have been obtained.

### Increases in Coverages and New Consents

As indicated above, the new notice and consent requirements must be met prior to any employer-owned life insurance contract being issued. Questions could arise regarding whether these requirements begin anew upon subsequent increases in coverage under the contract. For example, a policyholder-initiated increase in coverage often would be considered a "material change" to an existing contract under the Act's effective date provisions (discussed *infra*), which generally treat a contract as newly issued on the date of the increase. If a contract is considered newly issued on the date of a coverage increase, then new notices and consents might be needed prior to that date. This issue would arise most prominently in circumstances where the face amount was increased beyond the "maximum face amount for which the employee could be insured at the time the contract was issued." However, the question also could arise in situations where the face amount is increased but not beyond the maximum coverage amount originally disclosed to the insured.

### Reporting and Recordkeeping Requirements

The Act added Section 6039I to the Code, which imposes reporting and recordkeeping requirements with respect to employer-owned life insurance contracts. Specifically, employers must report (1) the total number of employees of the "applicable policyholder" at the end of the year, (2) the total number of employees insured at the end of the year, (3) the year-end total amount of coverage provided by the contracts, (4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which it is engaged, and (5) a statement that the applicable policyholder has a valid consent for each insured employee and, if all consents were not obtained, the total number of insureds for whom consents were not obtained. The applicable policyholder also is required to keep records necessary to determine whether the requirements of Sections 101(j) and 6039I are met. If the reporting and recordkeeping requirements are not satisfied, the employer could be liable for penalties, even if the death benefits under the associated life insurance contracts otherwise are excludable from income.

The reporting and recordkeeping requirements imposed by the Act require that certain information be provided on behalf of the "applicable policyholder."

The reporting and recordkeeping requirements imposed by the Act require that certain information be provided on behalf of the "applicable policyholder." As described above, that term is defined to include not only the entity that actually owns the relevant life insurance contract, but also certain related parties. As a result, employers will need to coordinate among the relevant related parties to collect the information required to be reported and to maintain the required records. This could present some practical implementation issues, for example, if obtaining information with respect to the number of employees of a related party or the life insurance contracts owned by a related party is difficult.

### Effective Date Rules

The new COLI best practices rules generally are effective for contracts issued after Aug. 17, 2006 (the "general effective date"), subject to two significant exceptions. Specifically, the new rules apply to contracts issued after the general effective date—except for a contract issued after such date pursuant to an exchange described in Section 1035 of the Internal Revenue Code of 1986 for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or

continued »20

other material change shall cause the contract to be treated as a new contract ...[14]

The language treating "material changes" to existing life insurance contracts as giving rise to "new contracts" for purposes of the effective date is typical of the Congressional approach to legislative enactments affecting life insurance contracts, such as the effective dates of Sections 7702 and 264(f). However, the language providing an exception to the general effective date for contracts issued in a tax-free exchange under Section 1035 is novel. The authors understand that the provision was included in the legislation at the urging of the banking industry, apparently in an effort to enable banks to switch products without subjecting themselves to the new rules. While such a goal is certainly worthwhile, the inclusion of the Section 1035 language in the effective date provision likely will result in considerable confusion.

In that regard, a "material change" in existing property generally refers to a change that is sufficiently fundamental that it is viewed for federal tax purposes as a disposition of the original property and the acquisition of new property in its place.[15] Consistently with this view, a material change to a life insurance contract generally is treated as an exchange of an existing contract for a new contract issued on the date of the material change.[16] Thus, "material changes" are a subset of the broader concept of "exchanges," and if a material change has occurred then an exchange has occurred for tax purposes

Despite material changes being a subset of actual exchanges, the Act can be read as contemplating circumstances in which an actual exchange of contracts could occur without the transaction resulting in a material change that triggers the Act's effective date. This circular language in the Act's effective date rule could be interpreted as providing an easy end-around the intent of the rule itself. For example, assume that a corporation purchased a COLI contract in 2005 and has not made any changes to the contract since then, such that the contract is not currently subject to Section 101(j). After Aug. 17, 2006, the issuer and the owner negotiate an increase in the minimum interest crediting rate under the contract If the parties implement this change by simply modifying the contract, the modification would be viewed as a material change for purposes of the Act's effective date rule, and the contract would become subject to section 101(j) as of the date of the modification. Alternatively, if the parties implement this change through a Section 1035 exchange of the existing contract for a contract issued on a new policy form, then arguably the Act's effective date would not be triggered because it specifically does not apply to "a contract issued after [Aug. 17, 2006] pursuant to an exchange described in Section 1035 of the Internal Revenue Code of 1986 for a contract issued on or prior to that date."

[14] Pub. L. No. 109-280 § 863(d). The effective date provision also includes an exception to the "material change" rule under which, in the case of a master contract (within the meaning of section 264(f)(4)(E)), the addition of new insureds is treated as a new contract only with respect to such additional insureds

[15] The Supreme Court has viewed properties as "different" in a sense that is "material" to the Code if the properties' respective legal entitlements were different in kind or extent. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 565 (1991).

[16] *See* S. PRT. NO. 98-169, at 579 (1984) (discussing the treatment of exchanged contracts as new contracts for purposes of the effective date of Section 7702 and suggesting that a change in an existing contract will result in an exchange)

While a literal reading of the Act's effective date provisions might lend some support to the foregoing conclusion, such a reading would render as meaningless the Act's other provisions dealing with material changes. As a result, a more appropriate reading of the statute may be that a Section 1035 exchange does not trigger the Act's effective date unless the exchange is accompanied by a change that is otherwise a material change. Thus, for example, if an employer exchanged Contract A for Contract B and all material provisions of the contract remained intact (other than the issuer), the exchange would not trigger the effective date rule. On the other hand, if in connection with that exchange the insurer agreed to materially increase the face amount of the new contract, the exchange would be viewed as triggering the Act's effective date rule.

While there are good arguments as to why this should not result in a material change ..... it is not clear whether the Internal Revenue Service (IRS) would agree with such an interpretation, at least in all circumstances.

Still other issues could arise in connection with the Act's effective date. For example, the Joint Committee on Taxation's explanation of the Act states that "[i]ncreases in the death benefit that occur as a result of the operation of Section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract."[17] Questions could arise under this language, such as whether the payment of an additional premium under a flexible premium life insurance contract will result in a material change if the premium payment causes the death benefit to increase as a result of the operation of Section 7702. While there are good arguments as to why this should not result in a material change (*e.g.*, the premium was paid pursuant to terms of the existing contract, and the premium payment did not require the insured's consent), it is not clear whether the Internal Revenue Service (IRS) would agree with such an interpretation, at least in all circumstances.

In light of the uncertainty surrounding the Act's effective date provisions, taxpayers would do well to adopt conservative interpretations that require compliance with the COLI best practices rules with respect to any contract that undergoes a change that is not clearly immaterial or that is involved in a Section 1035 exchange. In the case of a Section 1035 exchange, taxpayers also may wish to seek a private letter ruling from the IRS before entering into any transaction that might trigger the Act's effective date rules.

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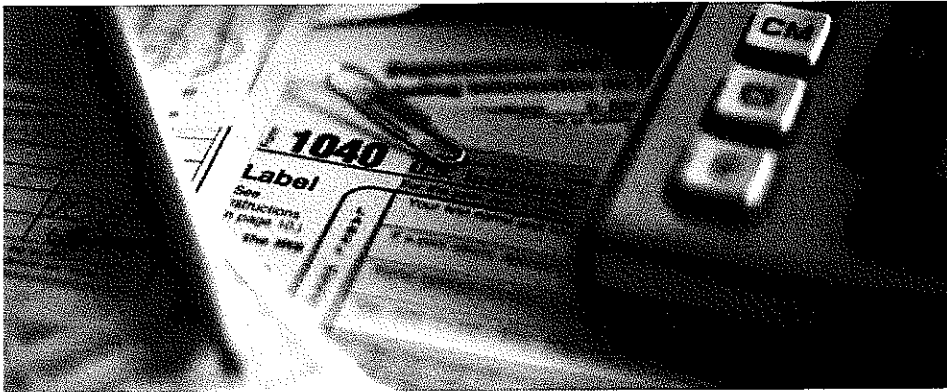
[17] 2006 Technical Explanation, *supra* note 11, at 212.

# FIN 48—An Interpretation

*by Frederic J. Gelfond*




*Some enterprises recognize all tax positions taken or anticipated to be taken in a tax return and include the anticipated to be taken in a tax return and include the effects of the uncertainty about the detection and sustainability of the positions in the deferred tax asset valuation allowance or analysis of the adequacy of the income tax liability. Other enterprises use a predetermined confidence threshold for initial recognition of benefits from tax positions and a probable loss threshold to provide for contingent losses related to the uncertain tax positions. Still other enterprises have identified uncertain tax positions based on certain attributes and then applied the guidance for gain contingencies in paragraph 17 of FASB Statement No. 5, Accounting for Contingencies.*

Financial Accounting Standards Board
Proposed Interpretaion No. 1215-001
July 14, 2005

## I. A New World Order

The above quote reflects the driving force behind the Financial Accounting Standards Board (FASB) July 2006 release of FASB Interpretation No. 48 (FIN 48); an effort to clarify the accounting for the uncertainty in income tax positions reflected in an enterprise's financial statements under FASB Statement No. 109, Accounting for Income Taxes (FAS 109). The FASB's goal in releasing FIN 48 is to enhance the relevancy and comparability of financial statements with respect to the reporting of income taxes.

The FASB recognized that while the validity of a tax position recorded in a financial statement is a matter of tax law, there are times when the tax law itself is subject to varied interpretation. As a result, it acknowledged that there can be uncertainty as to whether a particular position will ultimately be sustained. FAS 109, however, did not provide any specific guidance on how to account for this uncertainty resulting in significant diversity in practice.

In adopting FIN 48, the FASB has mandated that companies[1] move from a liability-based approach to an asset based approach to accounting for uncertainty in income taxes. That is, under current practice, companies generally record the entire amount of a tax benefit; i.e., there is an initial assumption of an entitlement to the benefit. That tax benefit, in turn, may be offset in whole or part, through a liability that is established based on the probability that such benefit will ultimately not be fully realized. Under this approach, the income statement tax provision and the balance sheet accounts are based on "as filed" tax returns.

In issuing the interpretation, the FASB determined that a liability approach as described above is not appropriate when a company cannot conclude, with a specified level of confidence, that it is entitled to report the economic benefits of a claimed tax position. As such, under FIN 48, companies will be required to first determine that a tax position meets a minimum recognition threshold before the associated tax benefit is reflected on a company's books, in whole, or in part. That is, there is no initial assumption of entitlement. Contrary to a liability approach, the income statement provision and balance sheet accounts will be based on an asset-based approach set forth in FIN 48, rather than on "as filed" income tax returns. Under this approach, the amount of tax benefit to be recognized on the financial statements with respect to a tax position that satisfies the minimum recognition

[1] FIN 48 refers to "enterprises" in addressing the entities to which it applies. Given that the majority of the readership of this journal is primarily interested in the application of the interpretation to insurance companies, the term "company" or "companies" is utilized for this purpose.

threshold is determined under a measurement process that is defined in the interpretation.

It is expected that in many instances, adoption of FIN 48 will require companies to undergo significant changes in tax accounting policies, procedures and internal controls.[2]

The remainder of this article provides a general walk-through of the major requirements set forth in FIN 48, highlights some of the further questions that have been raised by this "clarification" of FAS 109 and lists some of the things that companies should be doing to prepare for this whole new world of income tax accounting.

## II. Overview

FIN 48 provides a two-step process for recording a tax benefit on a financial statement. Step one involves satisfaction of a recognition threshold that requires a company to determine whether it is more likely than not[3] that the tax position will ultimately be sustained after all appeals and litigation processes. This determination must be based solely on the technical merits of the position. It is also necessary to assume that the position will be examined by the appropriate taxing authority and that the authority has full knowledge of all relevant information.

Once this step is complete, for those tax positions that meet the recognition threshold, the company must next measure the amount of the benefit that should be reported in its financial statements. This second step involves a process of evaluating the probability of possible outcomes that might occur. The amount that is required to be reported on the financial statements is the largest amount of tax benefit that is more than 50 percent likely to be realized upon ultimate settlement of the issue.

To the extent there is a difference between the amount that is or will be reflected on a company's tax return and the amount that is required to be reported on its financial statements, both or either of the following will occur:

1. an increase in a liability for income taxes payable and or a decrease in an income tax refund receivable, or

2. a decrease in a deferred tax asset or an increase in a deferred tax liability.

Tax benefits that are not recognized under FIN 48—"unrecognized tax benefits"—will be required to be reported as a current liability to the extent that payment of such amount is anticipated to occur within the longer of one year, or the company's operating cycle.[4]

If it is later determined that a tax position that is initially deemed to satisfy the FIN 48 more likely than not no longer meets that threshold, the tax benefit must be "derecognized" in the first subsequent financial reporting period in which the threshold is no longer met.

Similarly, a tax benefit that is initially not recognized on a financial statement because it did not meet the FIN 48 recognition threshold, but is later deemed to meet that test, must be recognized in the first subsequent financial reporting period[5] in which the threshold is met.

## III. The Devil in the Details

Despite the title of FIN 48, "*Accounting for Uncertainty in Income Taxes*," it does not provide a definition for, or limit its application to "uncertain tax positions." Instead, out of a concern there would be inconsistent application of the described standards; the FASB broadly applies FIN 48 to "all tax positions" accounted for under FAS 109.

The FASB does, however, provide a definition of the term, "tax position," and uses it to refer to:

> [A] position in a previously filed tax return or a position to be taken in a future return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods.[6]

continued >> 24

[2] See Christopher Barton *Implementing FIN 48: The Glass is Now Half-Empty*, Bureau of National Affairs, Income Tax and Accounting (2006)

[3] As discussed in the text below, for this purpose, the term "more likely than not" means, "a likelihood of more than 50 percent."

[4] This rule applies only when classified balance sheets are prepared. Insurance companies do not issue classified balance sheets; i.e., there is no such thing as a non-current asset or liability.

[5] Including interim periods

[6] FIN 48, paragraph 4

from pg 23

It further states that a tax position can result in either: (1) a permanent reduction of income taxes payable; (2) a deferral of income taxes otherwise payable; or (3) a change in the expected realizability of deferred tax assets, and that the term also includes, among other things:

1. a decision not to file a tax return,

2. an allocation or shift of income between jurisdictions,

3. the characterization of income or a decision to exclude reporting taxable income in a tax return, and

4. a decision to classify a transaction, entity, or other position in a tax return as tax exempt.

***Recognition***

Now that that is clear . . . sort of . . . one's initial reaction might be to move right to the initial step in the process; that is, determining whether the tax position meets the more likely than not threshold for recognition in the financial statements. Actually, however, there is a significant preliminary step that must occur before one applies the more likely than not test.

First one must determine the level of granularity, or unit of account, to use in identifying the tax position that is the subject of the prescribed more likely than not analysis. In developing the unit of account concept, the FASB did not believe that it would be possible to address every circumstance on how to determine a unit of account. It suggested that because of the fact-specific nature of a tax position and the company taking it, that a single defined unit of account would not apply to all situations.

Instead, it provided examples to illustrate some general principles on how to approach the analysis. In its initial example, it describes a company that has taken a research and experimentation tax credit with respect to four separate projects. In year one, the company determined that it would be appropriate to conduct its FIN 48 recognition analysis with respect to the tax credit on a project-by-project basis. In year two, facts and circumstances had changed such that the company determined that the appropriate unit of account was at the more detailed functional spending level, rather than the stand-alone project unit of account deemed appropriate in the prior year. Among the factors that the FASB indicated were critical to this decision in both years were (1) the level at which the company accumulated the information to support the tax return and (2) the level at which it anticipated addressing the issue with the taxing authorities.

The example also illustrates that in making the determination as to the unit of account, it may be necessary to disaggregate elements of a specific deduction; e.g., project by project versus individual project expenditures. Such disaggregation may significantly affect the amount of effort and documentation required in conducting the rest of the FIN 48 processes.

The discussion around the example states that the unit of account should be consistently applied to similar positions from period to period, but also further indicates that a change in facts and circumstances may make it appropriate to change to a different unit of account.

In an insurance context, an area potentially ripe for determination over the proper unit of account might involve a company's Section 807 reserves.[7] For example, one can envision a company making a determination that the appropriate unit of account is its total Section 807 reserves for an entire block of contracts versus, perhaps, a decision that its tax positions should be examined on a contract-by-contract basis. Alternatively, facts and circumstances at one company might dictate that the company deems it appropriate to use its aggregate Section 807 reserves for all lines of business as the unit of account. Meanwhile, another company might take a position that identifying the proper units of account would involve performing some sort of bifurcation of its Section 807 reserves into component pieces.

As indicated above, once the unit of account is determined, the more likely than not determination is to be based on the technical merits of a tax position relating to that unit of account. For this purpose, the term "more likely than not" means, "a likelihood of more than 50 percent."[8] It is intended to reflect a positive assertion that the company believes it is entitled to the economic benefits associated with the subject tax position.

[7] Section reference is to the Internal Revenue Code of 1986, as amended.

[8] FIN 48, paragraph 6.

Again, this is the fundamental underpinning of the way in which the FIN 48 asset recognition approach differs from the liability approach under current practice, in which there is an initial assumption that the tax benefits will be realized, with some form of allowance being established to account for the probability that the full benefit might not be achieved.

As also noted above, the more likely than not determination is to be based solely on the technical merits of the position. FIN 48 further provides that the analysis as to whether a position meets this threshold must consider all facts, circumstances and information that affect the technical merits of the tax position (*e.g.*, case law, rules and regulations) that are available at the most recent financial statement reporting date.[9] In addition, it must be assumed that the relevant taxing authority has full knowledge of all relevant information.

The interpretation further directs that the technical merits of a position are to be derived from sources in the tax law, including "legislation and statutes, legislative intent, regulations, rulings, and case law."

FIN 48 also provides that when past practices and precedents of a taxing authority with respect to either the subject company or other similar companies, become widely understood, such practices and precedents may be taken into account in making the more likely than not determination.

Despite its direction regarding making a determination based on sources in the tax law, reliance on administrative practice and precedents may, in certain instances, be relied upon under FIN 48 with respect to a position on an item that is technically contrary to the tax law. An example of such a scenario might occur in a situation where it becomes widely known that a taxing authority regularly examines companies in a particular industry on a position that constitutes a technical tax law violation, yet has consistently declined to propose an adjustment. In such case, it might be possible to rely on such knowledge in coming to a more likely than not decision on the position.

This does not mean, however, that a company can take a more likely than not position on an item that technically violates the tax law based on knowledge of the sole fact that other taxpayers have taken the same position and not been challenged on it. There must also be knowledge that the item was actually specifically examined and that the taxing authority affirmatively determined not to contest the item.

FIN 48 further provides that the analysis as to whether a position meets this threshold must consider all facts, circumstances and information that affect the technical merits of the tax position. ...

Finally, a company must evaluate each tax position separately. It is not permitted to consider the possibility of offsetting or aggregating different tax positions. A legal tax opinion is not necessarily required before a tax benefit can be recognized.[10] Obtaining a tax opinion from a qualified expert, however, can be used as external evidence that the tax position meets the recognition threshold.

In the event that a tax position does not meet the more likely than not recognition threshold, the associated tax benefit may not be recognized in the company's financial statements. As a result, the financial statement tax expense will be higher than that reflected in the company's tax return by the full benefit of the tax position. The company would then increase its financial statement tax expense by one or any combination of the following:

continued » 26

[9] *Id.*

[10] For additional insights on this issue, see the companion piece to this article, authored by Peter Winslow of Scribner Hall & Thompson LLP, that discusses, among other things, types of outside advice that can be obtained other than a formal tax opinion.

from pg. 25

1. recognizing a liability for FIN 48 unrecognized tax benefits;

2. reducing an income tax refund receivable;

3. reducing a deferred tax asset (*e.g.*, if the as-filed tax position increases a net operating loss carryforward); or

4. increasing a deferred tax liability (*e.g.*, if the as-filed tax position increases an asset's tax basis)

***Measurement***

Once a tax position is determined to have met the more likely than not threshold for recognition, the amount of the tax benefit to be reported on the company's financial statements needs to be "measured." The amount to be reported is "the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information."[11]

This part of the process involves consideration of the amounts and probabilities of each potential outcome that could be realized upon ultimate settlement of the issue. This determination is to be based on facts, circumstances and information available at the financial statement reporting date.

In a situation where the tax position is highly certain—for example, if the law is clear and unambiguous in a particular area—and company management is both highly confident in the technical merits of its position, and believes it would not accept anything less than the full benefit in a negotiated settlement with the taxing authority, then the company may report the full amount of the benefit on its financial statements.

It is also possible, however, that company management might believe it is more likely that not that a tax position would be sustained on its technical merits—and hence meets the recognition standard—but management would consider settling the issue if challenged by the taxing authority. In such case, the measurement process would be more involved.

The analysis would start with identifying the largest possible outcome that the company could realize in a negotiated settlement. The company would then make a determination as to whether there is a greater than 50 percent chance it would realize that amount upon ultimate settlement of the issue. If the company determines that the probability of receiving that amount is less than 50 percent, then the company must evaluate the probability of the next largest possible outcome occurring. This evaluation process continues until the cumulative probability of occurrence for an amount is greater than 50 percent. That amount gets recognized in the financial statements as a tax benefit.

To illustrate, assume a company has determined the following with respect to a given more likely than not tax position involving a potential $40 tax benefit the company reflected on its tax return. Management expects that it would negotiate a settlement of the issue if the tax position is challenged.

| Possible Estimated Outcome | Individual Probability of Occurring (percent) | Cumulative probability of occurring (percent) |
|---|---|---|
| $40 | 31 | 31 |
| **$30** | 20 | **51** |
| $20 | 20 | 71 |
| $10 | 20 | 91 |
| $0 | 9 | 100 |

[11] FIN 48, paragraph 8.

In this case, the company should recognize a tax benefit of $30, because that is the largest benefit that is greater than 50 percent likely of being realized in ultimate settlement

Similar to what occurs with respect to an item that does not meet the more likely than not recognition threshold, and hence is not recognized at all, the difference between the financial statement tax benefit and the full benefit is recognized as a higher financial statement tax expense. In the example above, the company would recognize a $10 FIN 48 income tax liability, assuming the item does not affect a deferred tax asset or liability.

If the difference between a FIN 48 amount and a tax return amount merely involves timing of the deductibility or includibility of an item, the overall tax provision—*i e.*, the sum of current and deferred taxes related to the item—will not differ[12] There will, however, need to be an adjustment between the relative portions of the tax asset or liability that are reflected as current and deferred

A company must have a reasonable, supportable basis for its assigned probabilities considering all available information surrounding the tax position. In assigning probabilities, it may consider factors such as the amount that is, or may be reflected in its tax return, its past experience with similar positions and the input of expert advice, among others

### *Subsequent Recognition, Derecognition and Measurement*

If a tax benefit is not recognized in the financial statements during the period in which the associated tax position was initially taken because it did not meet the more likely than not recognition threshold, it will need to be recognized in the first interim period in which it is met. This will occur when: (1) either the more likely than not recognition threshold is met by the reporting date (*i e.*, there has been a change in position); (2) the matter is ultimately settled; or (3) the statute of limitations for it to be challenged has expired.

As indicated by item (1) in the above paragraph, the determination as to whether a tax position meets the recognition threshold can change over time. For example there may be a change in case law, rules, or regulations subsequent to the initial reporting period that would cause a company to change its conclusion as to the technical merits of a tax position. If that is the case, a company's confidence level on a position may change from being not more likely than not, to being more likely than not. In that case, the company would be required to recognize the tax benefit in the first interim period in which the change occurs.

The reverse situation may also occur. If it does, the company will be required to "derecognize" the previously recognized tax benefit associated with the position. Unlike what is done under current practice, the company may not use a valuation allowance in lieu of derecognizing the tax benefit.

In the case of either recognition or derecognition, the change must be based on new information. The change may not be based on a new evaluation or interpretation of information that was available in a previous reporting period.

### *Changes in Judgment*

Subsequent changes in judgment from one annual reporting period to another are required to be treated as discrete items in the period in which they occur, and accounted for under current rules set forth in FAS 109 dealing with intraperiod tax allocations The effect of the change in judgment taken in a prior annual period is recorded entirely in the interim period in which there is a change in judgment. This is similar to the rules relating to taxes on an unusual, infrequently occurring or extraordinary item.

If the change occurs between interim reporting periods within the same annual reporting period, the accounting is governed by APB Opinion No. 28, *Interim Financial Reporting*, and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*. In this situation, the effect of the change in judgment is partially recognized in the quarter the judgment changes, with the remainder being recognized over the remaining interim periods; and incorporated into the annual estimated effective tax rate.

continued >> 28

[12] Except for interest and penalties that may need to be accrued, as discussed in the following text.

from pg 27

***Interest and penalties***

FIN 48 requires the reporting of interest and penalties with respect to differences between tax positions reported under FIN 48 and those taken or anticipated to be taken on a company's tax return. Interest is to be applied to these amounts based on the applicable statutory rate and is required to be recognized beginning in the first period the interest would begin accruing under relevant tax law. Any penalties that would be applicable, based on how a tax position is recognized and measured under FIN 48, must be recognized as an expense in the amount of the statutory penalty that would apply in the period in which the position is claimed or expected to be claimed in the company's tax return

Under U.S. federal income tax law, interest is generally accrued on underpayments of income tax beginning on the last date prescribed for payment of the tax. Therefore, for financial statement purposes, interest may not necessarily begin to accrue when an enterprise initially recognizes a FIN 48 income tax liability.

Penalties and interest may be subsequently derecognized when the tax position to which they relate is finally settled.

***Classification***

The illustration set forth in the above discussion on measurement describes how FIN 48 unrecognized tax benefits, or differences between amounts set forth on a company's financial statements and its tax return, are to be classified. Such amounts are to be recorded as current liabilities to the extent that it is anticipated payment or receipt of cash with respect to the associated tax position will occur within the longer of one year or the company's operating cycle [13] Such amounts may not be combined with deferred tax assets or liabilities. If, however, the application of FIN 48 has the result of creating or changing a taxable temporary difference, then it may be classified as a deferred tax liability.

Exceptions to these rules exist, including, for example, unrecognized benefits that reduce tax refunds or net operating losses.

With respect to interest and penalties companies have a few options. Interest amounts created as a result of applying this interpretation may be classified as either income taxes or interest expense, depending on company accounting policies. Similarly, penalties may be treated as either income taxes or some other expense, again depending on company accounting policy. In either case, however, the company must consistently apply its classification elections for these items

Companies cannot use the adoption to change their accounting for these items without establishing preferability. If a company recorded interest "above the line" before FIN 48, it will need to do so once FIN 48 is adopted unless the company can support that a change in policy is preferable.

***Disclosures***

FIN 48 also provides a rigorous set of disclosure requirements. These requirements include setting forth details regarding beginning and end of year unrecognized tax benefit amounts that must include, at a minimum, separate quantification of such amounts resulting from positions taken in prior years and the current year, as well as decreases in unrecognized tax benefits relating to settlements with taxing authorities and as the result of expired statutes of limitations

In addition, companies will be required to provide detailed information relating to:

- the total amount of unrecognized tax benefits that, if recognized, would affect the company's effective tax rate;
- amounts of interest and penalties recognized in the company's statement of operations versus its statement of financial position;
- details regarding the nature of positions for which it is "reasonably possible," that unrecognized tax benefits will significantly change within one year of the reporting date, including estimates of the amount of the possible change; and
- a listing of open tax years.

A company must also disclose its classification policies relating to interest and penalties

[13] As noted above, this only applies to companies that report on classified financial statements Insurance companies do not file classified financial statements

As one might have expected, the FASB received a number of comments indicating that it would be inappropriate to require such detail in the disclosures as doing so would provide a "roadmap" for taxing authorities The FASB provided several reasons for dismissing these concerns, including its recognition that in the United States there are now more detailed book-tax reconciliation requirements that must be filed with a company's tax return; presumably a reference to Schedule M-3. They contended that these new reconciliation requirements will be the sources of information the taxing authorities will rely on.

***Effective Date and Transition***

Companies are required to adopt FIN 48 with respect to fiscal years beginning after Dec. 15, 2006 Early adoption is permitted, but it must occur as of the beginning of the company's fiscal year, provided it has not yet issued any interim financial statements for the fiscal year

The interpretation applies to all tax positions, including those adopted in prior years. Because only those positions that meet the more likely than not recognition threshold may continue to be recognized, it is likely that in many instances an adjustment will need to be made upon the adoption of FIN 48. As such, the interpretation provides a means for companies to account for the cumulative effect of the change. The change in the year of adoption is to be reflected as a change in retained earnings or other appropriate components of equity or net assets in the financial statements. The amount must be presented separately, with a disclosure setting forth the amount of the change. Such disclosure is not required after the year of adoption.

The cumulative effect adjustment relates solely to items that would be reflected in earnings. With respect to tax positions related to business combinations, the amount of the adjustment due to adoption is the difference between the net amount of assets and liabilities recognized in the statement of financial position prior to adoption of FIN 48 and the net amount of assets and liabilities recognized as the result of applying FIN 48

## IV What About Statutory Accounting?

NAIC[14] staff is currently drafting an issue paper to address potential adoption of FIN 48 for statutory accounting purposes. It does not appear as though this process will be complete by year-end. It is likely that if any states adopt it for statutory accounting purposes, the first possible date for the changes to be effective would be in 2008.

## V. Conclusion

This new world of tax accounting represents a significant change in how companies will recognize and measure income taxes recorded in their financial statements. It is complex and far reaching, and creates significant new disclosure requirements. Companies should not underestimate either the substantive impact or the amount of resources that they will need to dedicate towards performing the required processes, not to mention the additional skill sets or subject matter experts that in many instances will need to be brought in.

Therefore, if nothing else is clear from this new guidance, it is apparent that companies will need to adapt their former reporting processes in order to effectively comply with FIN 48 This adaptation will need to encompass, at a minimum, the following major steps:

- Step 1a: Identify Tax Positions
- Step 1b: Determine Unit of Account
- Step 2: Evaluate Tax Position for Recognition
- Step 3: Measure Benefit to Be Recognized
- Step 4: Determine Classification
- Step 5: Accrue Interest and Penalties
- Step 6: Prepare Disclosures

More urgently, the effective date for adopting FIN 48 is fiscal years beginning after Dec. 15, 2006, including the first interim reporting period. Insurance companies are generally all required to report on a calendar year basis. As such, for any company that has not already started the FIN 48 adoption process, the above steps should begin just about . NOW!

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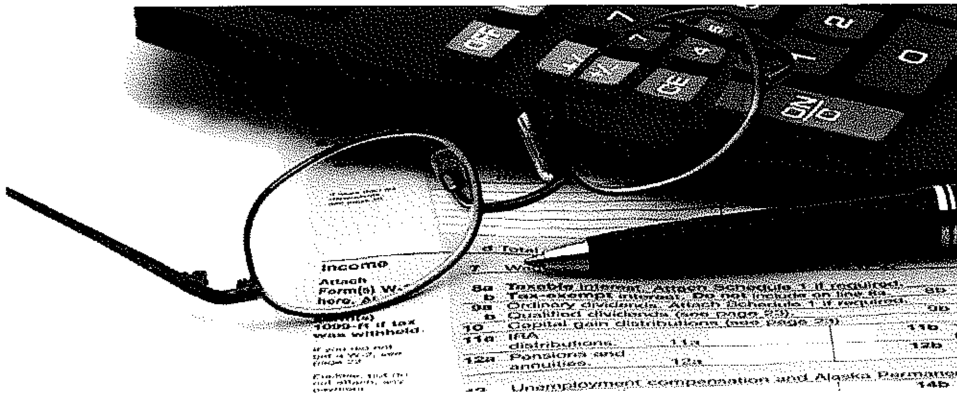
[14] National Association of Insurance Commissioners

# Role of Outside Tax Advisors in FIN 48 Compliance

*by Peter H. Winslow*

As company tax departments struggle to adopt their internal procedures to ensure compliance with FIN 48, an unmistakable trend seems to be developing—many in-house tax departments see a larger role for outside advisors in helping them establish, support and document the provision for uncertain tax positions. The reason for this upswing in outside advice is evident. When auditors examine the company's compliance, it would be natural for them to view a company's compliance process more favorably where the company has gone the extra step to obtain the assistance and advice of outside experts. This may be so even though the in-house expertise may be more than sufficient to comply with FIN 48 without assistance and regardless of whether the outside tax advisors actually contribute much additional expertise to the process. At least two principles are at work here. The first is that "neatness counts" when complying with FIN 48 and demonstrating compliance to auditors, and written documentation from outside tax advisors tends to be "neat." The second is that "the definition of an expert is someone from out-of-town"; auditors naturally may assume that a company has taken its FIN 48 compliance work seriously if outside expert advice has been sought on the largest and most complicated uncertain tax positions.

Outside advice on FIN 48 compliance can fall into three general categories: (1) documentation of legal analysis, support for a more-likely-than-not conclusion and the choice of the ultimate level of the tax provision; (2) ongoing monitoring of major developments that could result in a change in the provision; and (3) identification of events that likely could cause the provision to change within the next 12 months. Outside advisors probably will have less of a role in identifying the tax positions to be addressed, estimating the amount of tax, interest and penalties at stake and tracking statutes of limitations.



## Documentation support

There are several types of documentation from an outside tax advisor that might be used to support FIN 48 compliance. The most formal type of support is a legal opinion that addresses the probability that the tax position will prevail in the event it is questioned by the IRS on audit. The relevant level for a legal opinion under FIN 48 is that the tax position is "more likely than not" (more than 50 percent probability) to prevail. In light of IRS Circular 230 requirements imposed on tax advisors and legal malpractice risks, formal legal opinions tend to be expensive. For this reason, they probably will be used for FIN 48 compliance primarily for tax positions where large amounts are involved, and where the company needs a high degree of comfort. The other use of a formal legal opinion is the traditional one—to give greater protection against the possible assertion of penalties in the event the company's legal analysis turns out to be rejected.

Somewhat less formal and less expensive FIN 48 support can be achieved by a comprehensive memorandum from an outside advisor that describes the legal issues and their relative merits, but does not give a formal opinion as to the probability of success. This would be a legal memorandum, not a legal opinion, and would contain IRS Circular 230 language that the memorandum could not be relied upon for penalty protection. This type of memorandum might be particularly useful for FIN 48 compliance if it includes an outside advisor's advice as to a reasonable settlement range (i.e., the "value of the case") in the event the tax position were to be challenged by the IRS on audit. Although the memorandum might not set forth a more-likely-than-not opinion, an in-house tax department and its auditors might use the settlement range advice as their support for their own independent determination of the appropriate amount of the tax provision on the issue. We doubt whether outside tax advisors,

particularly law firms, will be comfortable going beyond advice on a settlement range to express a view as to the specific amount to be held as a tax provision (i.e., the greatest amount that is more than 50 percent likely to prevail). Tax lawyers are not accountants and their advice should not be a substitute for the in-house tax department's own independent judgment.

Written documentation from outside advisors to support FIN 48 compliance also might take even less formal and less expensive forms For example, these might include brief summaries of the legal issue and conclusions (with IRS Circular 230 language), assistance in drafting the company's own issue-by-issue analysis, memorializing legal research and/or a brief memorandum that confirms that the outside advisors have reviewed the in-house analysis and agree with it

In choosing whether, and how, to use documentation from outside advisors in the FIN 48 process, two additional considerations might arise First, if the outside advisors' written documentation is shown to auditors, the attorney-client privilege may be waived as a result of the disclosure. Second, and related to the first, there is always the danger that the documentation will be required to be turned over to the IRS on audit However, as a practical matter, preserving the attorney-client privilege and protecting legal analysis prepared by outside advisors from disclosure to the IRS may be a secondary concern in a post-FIN 48 environment.

## Issue Monitoring

Outside tax advisors might have an important role in monitoring significant events that may result in a change in a tax provision. Because mere changes in judgment are not supposed to result in revision in the amount of the tax provision, in-house tax personnel may look to outside advisors to help monitor and document reasons for a change in the amount of a provision that is required. An issue monitoring function might include formal periodic reports as to the status of the issue, which could notify in-house tax personnel of new developments on a tax issue or, conversely, verify that the status of an issue remains unchanged This type of formal report might help a company prove the negative to auditors—that there is no reason to change the amount of the provision.

The ultimate decision as to how best to use outside advisors in FIN 48 compliance will be based on a cost/benefit analysis.

## Events to Occur in 12 Months

Most events that may occur within the next 12 months that could affect the amount of a tax provision are best known to the in-house tax department These include whether it is likely that an IRS audit will end, that an IRS Appeals settlement will be reached or that a statute of limitations will run. However, outside advisors might be used to assist in monitoring other upcoming outside events. These could include the imminent issuance of regulations, IRS rulings or court decisions.

The ultimate decision as to how best to use outside advisors in FIN 48 compliance will be based on a cost/benefit analysis. Will the added benefit of being able to demonstrate support for the tax provision to auditors outweigh the added cost? This cost/benefit analysis, like FIN 48 compliance itself, probably will be determined both on an issue-by-issue basis and on a system-wide basis. For example, a company might adopt an overall policy, to be communicated to its auditors, that it will always seek outside confirmation of its legal analysis for large uncertain tax provisions with amounts over a certain threshold, but as to any particular issue the form of confirmation may vary depending on the circumstances. In any case, we expect the answers as to how best to comply with FIN 48 to be part of an evolving process as auditors articulate more clearly how they intend to review compliance.

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# T^3: *Taxing Times* Tidbits

## NAIC to Extend Actuarial Guideline XXXIX for Two Years

*by Peter H. Winslow*

Actuarial Guideline XXXIX (AG 39) sets forth valuation standards (CARVM) for variable annuity contracts with guaranteed living benefits (VAGLB). In general, the guideline provides that aggregate reserves for contracts with VAGLB must equal the sum of (1) aggregate reserves for the contracts ignoring both the future revenues and benefits from the VAGLBs after comparison to the cash values and (2) the sum of an accumulation of the aggregate VAGLB charges from the date of issue to the valuation date, subject to an aggregate asset adequacy analysis. AG 39 was written as a temporary stopgap guideline, pending a comprehensive study expected to result in the issuance of VACARVM. For this reason, the original AG 39 had a sunset date of Jan. 1, 2006.

Defining CARVM for variable annuities with VAGLBs, AG 39 became the tax reserve method required to be used for tax purposes under I.R.C. § 807(d)(3) for contracts issued after its adoption by the NAIC. However, the new valuation rules have presented some difficult tax compliance issues. It seems clear that the Standard Valuation Law, and therefore I.R.C. § 807(d), require both statutory and tax reserves to include a provision for VAGLBs. What is not so clear is the amount of that provision for tax purposes. Is the CARVM reserve for the contract under I.R.C. § 807(d) equal to the basic reserve, plus the accumulation reserve? Or, does it also include the additional provision for asset adequacy? Do either of the accumulation reserve or the asset adequacy addition have to be recomputed for tax purposes? If so, many of the same tax reserve issues that tax lawyers, accountants and actuaries are dealing with now in the context of developing VACARVM and Principles-Based Reserves are implicated. For example, if the asset adequacy portion of the reserve is part of the CARVM reserve, how is it recomputed for tax purposes, taking into account the interest rate and mortality tables prescribed by I.R.C. § 807(d)? How is it compared to net surrender values on a contract-by-contract basis? Whatever the answers to these questions may be, they probably will not be determined with any certainty for another two years. At the fall meeting of the NAIC, the Life and Health Actuarial Task Force amended the guideline to delay the sunset date to Jan. 1, 2008, in the hope that VACARVM can supplant AG 39 before that new sunset date.

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## Private Annuities Are Now Just Like Commercial Annuities If Purchased with Property

*by Susan J. Hotine*

On Oct.18, 2006, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) released proposed regulations addressing the tax treatment of an exchange of property for an annuity contract, whether it be a private annuity or commercial annuity contract. Prop. Treas. Reg. § 1.1001-1(j) and 1.72-6(e) provide that, if an annuity contract is received in exchange for property other than money, the transferor-taxpayer (i) realizes an amount equal to the fair market value of the annuity contract (as determined under tables prescribed by Treasury under I.R.C. § 7520 for valuing of any annuity, interest for life or term of years, or any remainder or reversionary interest) at the time of the exchange; (ii) is required to recognize the amount of the gain or loss, if any, at the time of the exchange, regardless of the transferor-taxpayer's method of accounting; and (iii) for purposes of determining the initial investment in the annuity contract under I.R.C. § 72(c)(1), will treat the amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract) as the aggregate amount of the premiums or other consideration paid for the annuity contract. In addition to not distinguishing between private and commercial annuity contracts, the proposed regulations do not distinguish between secured and unsecured private annuity contracts. However, the proposed regulations specifically would not apply to an annuity contract that either is a debt instrument subject to I.R.C. § §1271 through 1275, or is received from a charitable organization in a bargain

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sale governed by Treas. Reg. § 1 1011-2. The proposed regulations apply whether the property is exchanged for a newly-issued annuity contract or for an existing annuity contract. Also, if the exchange of property for the annuity contract is in part a sale and in part a gift, the proposed regulations would apply the same rules that apply under I.R.C. § 1001.

The proposed regulations generally would be effective for exchanges of property for an annuity after Oct. 18, 2006. Thus, the proposed regulations would not apply to payments under an annuity contract received in exchange for property before that date (*i.e.*, existing private annuities). Also, there is an April 18, 2007 effective date for a limited class of transactions in which the annuity issuer is an individual, the annuity obligation is not secured in any way and the property transferred is not subsequently sold or disposed of by the transferee for two years after the date of the exchange. For purposes of this latter requirement, a disposition includes a transfer to a trust (whether a grantor trust, a revocable trust or any other trust) or to any other entity even if solely owned by the transferor. The later effective date has been described as applicable only for "plain vanilla, family-style annuities." Comments on the proposed regulations are due Jan. 16, 2007, with a hearing scheduled for a month later, in February.

The proposed regulations ostensibly were designed with the intention of treating property exchanges for private annuities the same as exchanges for commercial or secured annuity contracts; to leave the transferor-taxpayer in the same tax position as the transferor that sells the property for cash and uses the proceeds to purchase an annuity contract The preamble thus indicates that, consistent with the proposed guidance, upon finalizing the proposed regulations, Treasury and the IRS propose to declare a decades-old ruling (Rev. Rul 69-74, 1969-1 C.B. 43) obsolete, effective contemporaneously with the proposed regulations. Rev. Rul 69-74 concludes that the gain realized on the exchange of appreciated property for a private annuity is recognized ratably over the duration of the annuity payout period, as part of the portion of each annuity payment that is not excludable from income.

Although the proposed regulations seem to be aimed at undermining the transferor-taxpayer's argument that an unsecured private annuity is a mere promise to pay and does not amount to "property" received in an exchange, it may be questionable whether the aim is achieved. The proposed regulations speak only in terms of property exchanged for an "annuity contract." What is the tax treatment of the transaction if the property is exchanged for a "private annuity" that does not contain the distribution-at-death provisions required under I.R.C. § 72(s)? If the "private annuity" does not contain the required distribution-at-death provisions, it is not an annuity for purposes of the Code. *See* I.R.C. § 72(s)(1). Presumably, the proposed regulations would not apply. Would the installment sale rules then apply?

**Maybe an installment sale would be better**—The preamble to the proposed regulations notes that taxpayers are free to choose to dispose of property under the I.R.C. § 453 installment method, provided the requirements of such section are met. Under I.R.C § 453(a), income from the sale of real property or a casual sale of personal property, where any payment is to be received after the taxable year of the sale, must be taken into account under the installment method unless the transferor-taxpayer elects out in a timely manner.[1] Thus, an installment sale is defined broadly as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. *See* I.R.C. § 453(b)(1). The disposition of property for any I.R.C. § 72(s) disqualified "annuity contract" would meet this general definition. So, what would be the consequences? Under an installment method, the transferor-taxpayer recognizes income from the disposition of the property with each installment payment received, the income being that proportion of the payment received in a year which the gross profit bears to the total contract price; the taxpayer also recognizes an interest charge and recovers basis ratably over the installment period similar to the recovery of basis with the exclusion ratio under I.R.C. § 72(b). In fact, regulations prescribe how basis will be recovered "ratably" even where the gross profit or the total contract price cannot be readily ascertained. *See* I.R.C. § 453(j)(2); Temp. Treas. Reg. § 15A.453-1(c)(2)-(4) In contrast with the treatment given for property exchanged for an annuity contract, under the installment method, the gain from the property disposition would be taken into income only as each installment payment is made[2] and, with the exception of the interest charge, such installment income would be treated as gain from the disposition of the property (*e.g.*, capital gain).[3] The preamble to the

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[1] I.R.C § 453(e) also provides for a termination of the installment method where the sale is to a related person and there is a subsequent resale of the property within two years of the initial sale

[2] Note that I.R.C. § 453(f)(4) provides that receipt of a bond or evidence of indebtedness that is payable on demand or readily tradable is treatment as receipt of payment. On the other hand, evidence of indebtedness from the transferee that is guaranteed by another party is not a payment. See I.R.C. § 453(f)(3)

[3] This installment method provides treatment for the transferor-taxpayer that is very similar to that of Rev Rul. 69-74, which provides that a portion of the income received under the annuity would be taxed as capital gain and the rest as ordinary income

from pg 33

proposed regulations requests comments on when an exchange of property for an annuity contract should be treated as an installment sales. Perhaps the answer should be "when the contract is not an annuity." Lack of distribution-at-death provisions required under I.R.C. § 72(s) would be evidence of same.

## Deferred Compensation Transition Relief Extended Through End of 2007

*by Mark H. Kovey*

Section 409A, enacted in late 2004, imposed new restrictions on nonqualified deferred compensation plans that require many employers to amend existing plans to bring them into compliance with the new law. Prior to its enactment there was little guidance, other than Internal Revenue Service (IRS) guidelines for private rulings, as to the standards for successfully deferring compensation under these popular plans. The new law has changed deferred compensation practices because, among other matters, it restricts the use of certain trusts to hold deferred amounts, limits when participant elections must be made to defer compensation and specifies when, and what form of, distributions can be made to participants.

Notwithstanding that Section 409A is effective generally to amounts of compensation deferred after Dec. 31, 2004, Notice 2005-1 provided initial guidance on implementing the new rules and transition relief for existing plans that were not in compliance with the new law. The relief provisions allowed employers, in many cases, to rely on the prior law through the end of 2005, provided they operated the plan in reasonable, good faith compliance with the new provisions and amended the plan to satisfy Section 409A by the end of 2005. On Oct. 4, 2005, proposed regulations under Section 409A were published that clarified and extended the transition relief. Anticipating that the final regulations would be made effective on Jan. 1, 2007, the preamble to the proposed regulations provided that amendments to bring existing plans into compliance with the new law generally did not have to be made until Dec. 31, 2006. Now, Notice 2006-79 extends the transition relief for most issues through the end of 2007. The final regulations are expected to be issued early in 2007, but with a delayed effective date of Jan. 1, 2008, to allow extra time for taxpayers to analyze the final regulations and bring their plans into compliance. The IRS has suggested that this is the last extension for transition relief.

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Plans must be not only brought into compliance by Dec. 31, 2007, but also operated in good faith compliance in the interim. For example, the extension allows extra time to change an election to accelerate the payout to a participant of previously deferred amounts, provided the election change and any required amendment to the plan documents are made before Dec. 31, 2007. Therefore, a plan may provide, or be amended to provide, for new, different or accelerated distribution elections with respect to the time and form of payment of deferred amounts, and the new or changed election will not be treated as violating Section 409A.

However, Notice 2006-79 contains a "blackout" period for 2007, similar to the blackout period for 2006 under the transition relief in the proposed regulations. Consequently, no change to the plan and no election can be made under Notice 2006-79 in 2007 that causes an amount to be paid in 2007 when it would otherwise not be payable in 2007 or that impacts on an amount that would be payable in 2007.

Notice 2006-97 also extends the transition relief for making new deferral elections, payments linked to qualified employee benefit plans and the substitution of non-discounted stock options and stock appreciation rights (SARs) for discounted stock options and SARs. (Notice 2006-79 has no impact on those non-discounted stock options and SARs that are excluded from section 409A.) However, transition relief is not extended for those discounted stock rights that are subject to certain Securities Exchange Act disclosure and financial expense reporting rules. The IRS explained these are the types of stock rights which are involved in concerns over back-dating.

In a related area, an IRS official stated at a public seminar that the issuance of the final regulations under Section 409A will coincide with the IRS requiring employers to undertake reporting and withholding of income inclusions for 2006. The extension of transition guidance in Notice 2006-79 does not apply to information reporting and withholding obligations on deferred compensation that is includible in income under Section 409A. The official expected that employers will receive sufficient guidance to begin reporting and withholding by that time.

## Court of Appeals to Reconsider *Murphy* Case

*by Samuel A. Mitchell and Peter H. Winslow*

Tax lawyers and administrators normally do not have to think about the U S Constitution, but all that changed in August. On Aug. 22, 2006, for the first time in over 85 years, a court struck as unconstitutional a Congressional attempt to exercise its authority to tax income. In *Murphy v. United States*, the U.S. Court of Appeals for the District of Columbia held that I.R.C. § 104(a)(2) is unconstitutional to the extent that it permits taxation of items that are not income. 460 F.3d 79 (D.C. Cir. 2006). Specifically, the court held that damages awarded a plaintiff in a whistleblower suit for emotional distress, mental anguish and loss of reputation are recoveries of human capital and not "accessions to wealth." Based on a theory that taxpayers have no income in gaining emotional strength or reputation, the court held that an award for damages to compensate for the loss of these items is not income which Congress is authorized to tax under the 16th Amendment. The court essentially held that, unlike damages to compensate for future earnings that otherwise would have been taxed if earned, damages for emotional distress, mental anguish and loss of reputation merely return an individual to the *status quo ante*. As such, the court held that the damages are analogous to a nontaxable return of capital.

Practitioners widely criticized the *Murphy* case and the government views it as a matter of "exceptional importance to the administration of the nation's tax laws." Accordingly, the government filed a petition to have the case heard by the entire appeals court. (Petition for *en banc* review filed Oct. 2, 2006.) Perhaps in response to the heavy criticism the three-judge panel that originally heard the case recently vacated the earlier opinion and agreed to reconsider the case. (Order issued December 22, 2006.) In the order for reconsideration, the court vacated the earlier opinion, held that the government's petition for rehearing by the full court is moot, and ordered new briefing of the issues. This was a highly unusual move by the three-judge panel, and may signal a change in the result. The case will be argued again in April 2007.

The case is interesting and perplexing from a theoretical standpoint because I.R.C. §104(a)(2) is not a taxing provision, but rather is an exclusionary provision. I.R.C. § 61 broadly defines gross income to include any accession to wealth. I.R.C. § 104(a)(2) excludes from gross income "the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." In the vacated opinion, the court held that the plaintiff's damages for emotional distress, mental anguish and loss of reputation did not fall within this exclusion. Normally that would be the end of the matter. However, the court went on to conclude that, to the extent the exclusion permits the taxation of such items, it violates the 16th Amendment because such items are not income. In other words, the court held that I.R.C. § 104(a)(2) is unconstitutional, not because it taxes anything, but because it does not contain a broad-enough exclusion from taxation. Thus, as the government pointed out in its petition for *en banc* review, the decision would require Congress to enact an exclusion from gross income for the type of damages the plaintiff suffered.

The return of capital analogy is another interesting theoretical aspect of the case. This one has wide-ranging implications that may extend beyond I.R.C. § 104 situations if the plaintiff succeeds on reconsideration. A return of capital is not taxable because it merely restores basis that already has been taxed. For example, a company that issues a debt instrument is not taxed on the principal, but only on the interest that accedes to its wealth. Normally, the taxpayer must have a cost basis in order for the return to escape taxation. Courts have held that, because a person does not have a cost basis in items such as health, compensation for the loss of such items can be considered an accession to wealth. *E.g. Roemer v. Commisioner*, 716 F.2d 693 (9th Cir. 1983). The court in this case disagreed, holding that it was not necessary for the plaintiff to have a cost basis in her emotional and mental health and reputation because damages to compensate for the loss of these items merely restored her to the *status quo ante*.[1] As such, the court held that the damages do not represent an accession to wealth. This aspect of the holding, if it survives on reconsideration, may have wide-ranging implications because it calls into question the constitutionality of numerous Code provisions that result in taxation of items of gross income without permitting appropriate recognition of the taxpayer's cost basis.

There are other, basic Constitutional issues that will merit review on reconsideration. For example, in the petition for *en banc* review the government asked the full court to consider whether the government's authority to tax income derives from the 16th Amendment or from the basic taxing authority found in Article I

continued ......>> 36

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[1] The government's stated answer to the human capital argument is that taxing damages for loss of health is not qualitatively different from taxing an award for loss of future earnings without an offsetting deduction for the exhaustion of a person's physical and mental prowess over the earnings period. (Petition for Rehearing, citing Boris Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* (3d ed 1999)). The government points out that the courts have uniformly rejected the human depreciation argument.

from pg 35

"to Lay and Collect Taxes, Duties Imposts, . . . ." According to the government, the court's three-judge panel missed the mark because the 16th Amendment merely removed the restriction on taxation of income from the apportionment and other requirements set forth in Article I, § 9, cl. 4. In other words, the government is arguing that the 16th Amendment merely governs how income can be taxed, and not whether it can be taxed. In opposition, the plaintiff contended that the government waived this argument by not raising it at trial or on appeal. (Response to petition for *en banc* review filed Oct. 31, 2006). Because of the significance of the case, the three-judge panel will most likely address this argument on reconsideration even though it was not raised the first time around.

On a more practical level, the case calls into question how structured settlements should be drafted and other issues of an administrative nature, such as whether an insurance company will continue to have a tax reporting obligation for the payment of unconstitutional I.R.C. § 104 items. For now, these issues are confined to the narrow geographic area covered by the D.C. Circuit (i.e., Washington, D.C.). However, if the government does not succeed on reconsideration, it almost certainly will seek Supreme Court review. Given the basic constitutional and tax administration implications of the case, odds are the Supreme Court will grant review if the government asks. This will not necessarily be the case if the government wins on reconsideration because the Supreme Court traditionally grants deference to the government's petitions for Supreme Court review that it does not afford to private litigants. Thus, the plaintiff, if she loses, is much less likely to gain entry to the Supreme Court

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## Proposed Regulations on Capitalization of Tangible Assets Defer Decision on the De Minimis Rule

*by Samuel A. Mitchell and Peter H. Winslow*

The Internal Revenue Service (IRS) recently released proposed regulations under I.R.C. § 263(a) that clarify and expand current regulations regarding amounts paid to acquire, produce or improve tangible property. (REG 168745-03, August 21, 2006.) The rules provide a number of bright lines and safe harbors for application of the 12-month rule, treatment of repair and improvement expenses and other items such as unit of property rules that may not be of great interest to insurance company taxpayers. One area of interest to insurance companies and actuaries may be the IRS' discussion of a so-called "de minimis rule" under which small capital expenditures are routinely expensed for tax purposes as a matter of convenience, without any express legal authority to do so in the Internal Revenue Code or regulations. The proposed regulations do not include a de minimis rule, but the preamble solicits comments on whether to include a de minimis rule in the final regulations. The IRS held a public hearing on Dec. 19, 2006, but the de minimis rule was not a major topic of discussion.

Many taxpayers have informal agreements with IRS agents that acquisition expenditures in amounts below a certain threshold are off limits for examination—the de minimis rule. Although the proposed regulations do not contain a de minimis rule, the preamble contains a specific statement that the IRS does not intend this omission to disrupt current informal agreements. The IRS apparently considered adopting in the proposed regulations a de minimis rule that would set certain threshold amounts that would key off a taxpayer's written policies for expensing amounts paid for tangible property costing less than a certain dollar amount on its Applicable Financial Statement (AFS). Taxpayers without an AFS would have been subject to different, lower threshold amounts. The thresholds would not have applied to inventory property, improvements, land or components of a unit of property. The preamble solicits comments on whether the final regulations should retain the current informal agreement practice or adopt a rule similar to the AFS rule discussed above. Assuming a rule is adopted, the preamble requests comments on a variety of issues such as the proper threshold amounts, the scope of the rule, whether the rule should permit taxpayers and IRS agents to agree on higher thresholds, and whether a change to a new method should be treated as a change in method of accounting.

The preamble suggests that the IRS has an open mind on this issue and we can anticipate some flexibility on the part of the IRS National Office regarding the operation of the de minimis rule. This may be useful in dealing with agents who have not been flexible on this issue.