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Proration for Segregated Asset Accounts—How Is the Company's Share Computed?

by Susan J. Hotine

As the life insurance industry has issued more and more variable annuity and variable life insurance contracts based on segregated asset accounts, and those accounts have been invested in securities paying intercorporate dividends eligible for the 70- and 80-percent dividends-received deduction (DRD), the question of how a company should determine the amount of its DRD associated with segregated asset accounts has increased in significance. Because the insurance company is entitled to the company's share of the DRD associated with the dividends it receives, how does the company compute the company's share?[1] Why do life insurance companies enjoy only a share of the DRD benefit? The simple answer to the latter question is, because of the application of the concept of proration. We toss around the term, but what does proration mean?

What is proration? — "Proration" is a descriptive term referring to the fact that, for life insurance companies, the Internal Revenue Code[2] provides that each and every item of investment income received by a life insurance company be allocated pro rata between the policyholders and the company in accordance with certain percentage shares—the policyholders' share and the company's share. Under the Life Insurance Company Tax Act of 1959 (1959 Act), which created a three-phase structure for taxing life insurance companies (under which life insurance company taxable income was the lesser of taxable investment income (Phase I) or gain from operations (Phase II), plus 50 percent of the amount by which gain from operations exceeded taxable investment income, plus amounts subtracted from the policyholder surplus account (Phase III)), amounts of investment yield allocated to policyholder liabilities as the policyholders' share were not included in either taxable investment income or gain from operations. Thus, the concept of the policyholders' share and the company's share was integral to the 1959 Act because it had an impact not only on the computation of the tax benefits enjoyed by the company with respect to tax-exempt interest and the DRD, but also on the computation of a company's taxable income base (*e.g.*, a company (otherwise known as a Phase I company) could be taxed only on its taxable investment income which generally was computed as

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[1] Unlike most other corporations, a life insurance company is not allowed a full DRD for the amount of dividends it receives. I.R.C. § 805(a)(4)(A) allows a life insurance company a deduction (i) for 100 percent dividends received, and (ii) for the life insurance company's share of the dividends (other than 100 percent dividends) received. Also, I.R.C. § 807(a) and (b) provide that, for purposes of computing decreases and increases in reserves, respectively, the closing balance of reserve items is reduced by the policyholders' share of both tax-exempt interest and the increase for the taxable year in policy cash values of certain life insurance, annuity and endowment contracts.

[2] References to "I.R.C. §" or "Code" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

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SOCIETY OF ACTUARIES

FROM THE EDITOR

BRIAN G. KING

Hello readers! This September issue of *Taxing Times* marks our final issue for 2007. As I look back over the past year, I am pleased with the amount of tax information that we were able to make available to our members through our articles. I can honestly say that the abundance of good articles that make their way to my desk as editor of *Taxing Times* makes my job pretty easy. Our authors, through their articles are providing really good, useful information to our membership. This exchange of tax knowledge is one of the fundamental objectives of our section.

And *Taxing Times* is not the only vehicle for getting good tax information from the Society of Actuaries (SOA). *The Actuarial Practice Forum* (APF), published quarterly by the SOA, is an electronic forum designed to deliver in-depth papers on a wide range of topics to the general actuarial membership. The APF also provides an avenue for discussion of papers already published in earlier issues. Chris DesRochers' article in this issue of *Taxing Times* summarizes a Principles-Based Reserve Paper that he and Doug Hertz authored for the forum. If you haven't already seen the paper in its entirety, we encourage you to access it on the forum page of the SOA Web site (www.soa.org).

So much information is available and I encourage all of you to find it. Frederic Gelfond's FIN 48 article published in the February 2007 issue of *Taxing Times* provided one perspective on this topic. In the March 2007 issue of *The Financial Reporter,* published by the Life Insurance Company Financial Reporting Section of the SOA, another perspective on the FASB Interpretation was presented by authors Robert Frasca and Vincent Tsang. Gathering information on a tax topic from a variety of different sources and different perspectives provides our membership with the multi-disciplinary approach to tax issues that we established as a major goal of our section.

The SOA's newly designed Web site also provides access to a tremendous amount of tax information. The "Research & Resources" page of our Taxation Section Web page provides entire copies of many of the notices and regulations discussed in our articles. This is a good medium for gaining additional, in-depth information on a topic that interests you. In addition, the "Suggestions" section of our section Web page provides all of you with a forum for giving us feedback on what topics, research or activities you feel the Taxation Section should pursue.

Much information on insurance tax issues is available. While our own *Taxing Times* provides an outstanding vehicle for bringing you tax knowledge, it is by no means the only source. More information and different perspectives are out there. I encourage you to explore them.

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

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

I am pleased that *Taxing Times* has received its first ever "Letter to the Editor." In the interest of fairness, we have also published a response to the letter by the author of the referenced article. I encourage more "Letters to the Editor" as they provide an excellent venue for dialogue and discussion.

Brian G. King

June 21, 2007

Dear Mr. King:

I would like to comment on the opinions expressed by Christian DesRochers in his dialogue with Peter Winslow, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II)," that appeared in the May 2007 issue of *Taxing Times*. Mr. DesRochers suggests that Principles-Based Reserves (PBR) may not qualify, at least in part, as life insurance reserves as defined in I.R.C. § 816(b) and may not be deductible as recomputed under I.R.C. § 807(d). He elaborated on the *Taxing Times* Dialogue in the May 2007 issue of the Actuarial Practice Forum with Doug Hertz, "Treading into the Thicket: Federal Income Tax Implications of Principles-Based Reserves."

First, Mr. DesRochers and Mr. Hertz should be commended for their thoughtful analysis and significant contributions to the discussions on the tax issues relating to PBR. But, I must disagree with the basic premise that PBR cannot fit into existing tax law and therefore will not be deductible under I.R.C. § 807(d).

As I read the commentaries, two major concerns with a tax deduction for PBR are discussed: (1) only formulaic reserves based on net premium valuation methodology qualify as life insurance reserves; and (2) reserves that are based on intentionally conservative assumptions are nondeductible "solvency reserves" because they exceed the expected value of the liability. These basic concerns appear to lead Mr. DesRochers, and potentially his readers, to arrive at what are erroneous conclusions on these and several other related issues currently being considered when determining if PBR fit into existing tax law (*e.g.*, the role of expenses, lapse assumptions, company experience, dynamic assumptions, etc.).

However, neither of the two basic arguments bears up under legal scrutiny. As support for the first premise, Rev. Rul. 77-451, 1977-2 C.B. 224 and GCM 37209 are cited. This ruling and GCM concluded that an additional reserve for substandard risks under group conversion policies did not qualify as a life insurance reserve under the predecessor of current I.R.C. § 816(b) because the reserve was computed using a gross premium method. The IRS ruled that only reserves computed using a net premium valuation methodology where prospectively computed reserves equal retrospectively computed reserves qualify as life insurance reserves. I agree that, if the rationale of Rev. Rul. 77-451 and GCM 37209 were to be applied to PBR, life insurance reserve qualification would be questionable. However, it is doubtful whether the ruling and GCM 37209 are correct or have any continuing validity.

First of all, nothing in I.R.C. § 816(b) mandates a net premium valuation method. It is true that life insurance reserves must be computed based on recognized mortality tables and assumed rates of interest, but that does not mean that other factors cannot be considered. *See Lincoln National Life Ins. Co.* v. *United States,* 582 F.2d 579 (Ct. Cl. 1978); *Mutual Benefit Life Ins. Co. v. Commissioner,* 488 F.2d 1101 (3d Cir. 1974), cert. den., 419 U.S. 882 (1974). Moreover, even assuming that the IRS' 1977 position has continuing validity, it would only affect the qualification of the company as a life insurance company, not the deductible amount of PBR. Under this analysis, the company would be taxable as a nonlife insurance company because it would flunk the 50 percent reserve test in I.R.C. § 816. However, it still would be an insurance company and its tax reserves still would be required to be computed under I.R.C. § 807(d) (I.R.C. § 832(b)(4)) because they could satisfy I.R.C. § 816(b) if properly computed. *See* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, H.R. 4170, 98th Cong., Pub. L. 98-369, p. 598 (1984). Unlike the IRS' reading of the requirements of former I.R.C. § 801(b), I.R.C. § 807(d) does not contemplate that the deductible amount of each life insurance reserve must be computed using a net premium valuation method. In fact, the type of reserves at issue in Rev. Rul. 77-451 are capped using a gross premium method under I.R.C. § 807(e)(5)(D) if a separate premium for the substandard risks is charged. In other words, under the 1984 Act, Rev. Rul. 77-451 and GCM 37209

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are only relevant, if at all, to the classification of the company as a life or nonlife insurance company, not to the amount of the deduction.

The suggestion that all or some part of PBR should be held to be non-deductible solvency reserves because they are based on conservative assumptions also is erroneous. It has long been recognized that life insurance reserves are not required to be determined based on the best estimate of the expected liability. *E.g., Lamana - Panno - Fallo Industrial Ins. Co. v. Commissioner,* 127 F.2d 56 (5th Cir. 1942). The key question is: what is the reserve held for, not, is the amount of the reserve excessive? If the reserve is held for future unaccrued claims and is required by law, it qualifies as a deductible reserve. The Supreme Court has held that, in resolving the question as to the appropriate amount of reserves, Congress intended to underscore the primacy of state regulation. *United States v. Consumer Life Ins. Co.,* 430 U.S. 725 (1977).

I firmly believe that the goals of PBR are fully consistent with the requirements of the Code as written and their deductibility is clearly supported by the legislative history and caselaw. The drafters of PBR intend a reserve based on economic reality to be held for future contractual benefits. A solvency reserve, and an unreasonably high reserve, are not the goal. Equally important, there is no reason to suppose that Congress' deference to the NAIC and state regulation that has been the cornerstone of insurance taxation and tax reserve computations for over 80 years, and was expressly incorporated into the 1984 Act, will be discarded with the adoption of PBR.

At the end of the day, while I understand the need to address detailed statutory construction legal issues, I think that several commentators on PBR overlook that Congress' efforts under 807, both in 1984 and 1987, were an attempt at establishing a tax reserve "method" that was in effect more "principled-based" (*e.g.,* use of market interest rates, not allowing a reserve computation based on something more than the actual premiums, etc, etc.). How can an actuarial movement toward that same goal cause concerns that it will not fit into existing tax law? My answer to that question is; only if the person answering the questions wants that result.

Sincerely yours,
Thomas Gibbons

Response to Thomas Gibbons

by Christian DesRochers

I would like to thank *Taxing Times* for the opportunity to respond to Mr. Gibbon's letter dated June 21, 2007. One of the goals in writing the paper, as well as the *Taxing Times* dialogue was to generate discussion, so I appreciate Mr. Gibbons' efforts in taking the time to respond, although I take exception to the characterization of the conclusions as "erroneous." Mr. Gibbons has identified two critical issues related to the tax treatment of principles-based reserves (PBR). First, can reserves other than net premium reserves qualify as life insurance reserves and be treated as deductible reserves under section 807? Second, will the stochastic element of PBR be considered a solvency reserve, which has historically not been deductible?

Historically, statutory reserves have been net premium reserves. The CRVM method, which is the current basis for federally prescribed reserves, is a net premium method, so there is no precedent for other than net premium reserves. Even if the 1977 revenue ruling and GCM are no longer valid precedents, the issue is whether a reserve that includes a provision for non-guaranteed elements and expenses will meet the historical reserve criteria, which has been to limit reserve treatment to provisions for future unaccrued benefits.

Another long-standing principle has been that not every reserve that is either required or allowed by state regulators is deductible. The stochastic reserve is based on a distribution of economic scenarios, with the reserve set, not at the average value of the scenarios, but based on some part of the tail of the distribution. This may be problematic in itself, but the fact that the reserve must be allocated to individual contracts, and is based on a series of interest rates and not one interest rate assumption (which seems to be implied by section 807) are all issues that must be resolved.

I believe that discussion is healthy and thank Mr. Gibbons for his comments. I would invite others to contribute through articles or letters to the editor.

FROM THE CHAIR

LESLIE J. CHAPMAN

Our SOA Tax Council is focused on providing actuaries with forums to grow their knowledge-base regarding taxes. One of the ways we do this is by sponsoring tax sessions at SOA meetings, as well as co-sponsoring tax-related seminars.

Looking ahead to the fall, our council is putting together two high-quality tax sessions for the SOA Annual Meeting in Washington, D.C. The first session, "Update—Recent Tax Guidance," is designed to provide an update on significant developments in the area of tax practice related to life and health insurance companies, products and services over the last six to 12 months. Our goal is to have you leave this session with the most recent tax guidance that is essential to your work!

Our second tax session at the Annual Meeting is entitled, "More than MECs—Actuarial Elements of the Tax Law." Most actuaries are aware of the primary actuarial elements of the U.S. federal tax law; that is, actuarial tax reserves and the definition of life insurance and MECs. But, there are a number of other elements of U.S. tax law that are actuarial in nature; we invite you to attend this "More than MECs" session to learn how many other opportunities there are within the tax law for actuaries to ply their trade.

Later this fall, on November 5-7, the SOA Tax Section is sponsoring the Federal Tax seminar and is co-sponsoring the Capital Efficiency seminar with the Financial Reporting and Joint Risk Management sections. These back-to-back seminars will complement each other well; the Federal Tax seminar will be held the first day-and–a-half and the Capital Efficiency seminar, covering the remaining day-and-a-half, will then leverage the tax information that attendees have learned.

The Capital Efficiency seminar will focus on how to measure risk and value of business decision-making, including tax decisions, using economic measures such as Embedded Value and Economic Capital and how to integrate these measures into your ERM and rating agency review process. And, most importantly, the seminar will also address how to use these new risk and value measures to strategically manage your insurance business, including taxes. We will cover practical steps on how actuaries can use the information to make significant contributions to their employers, through discussions of tax strategy, reinsurance and capital market solutions. Come join us in Atlanta in early November for this lively discussion!

As you can see, we take seriously our charge to provide actuaries with opportunities to substantially increase their knowledge-base regarding taxes. Our sessions at the Spring SOA meetings were well attended and presented excellent networking forums. We're looking forward to a productive fall 2007 series of tax-related meetings and seminars!

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

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investment yield, less the policyholders' share of investment yield, less the company's share of tax-exempt investment income and of the deduction for dividends received).[3] While the primary reason for proration under the 1959 Act was to determine the amount of investment income that would be taxable to the company, the practical effect of it was to treat additions to reserves from investment earnings as funded in part out of tax-exempt interest and deductible intercorporate dividends, limiting the tax benefit a company could enjoy from these tax-favored items.[4]

With the enactment of the Deficit Reduction Act of 1984 (1984 Act), Congress concluded that the proper measure of the income of life insurance companies could be obtained by replacing the complex, three-phase structure with a simpler, single-phase tax.[5] Although the distinction between taxable investment income and gain from operations was eliminated, the Code provisions as enacted under the 1984 Act retained the general concept that items of investment yield should be allocated between policyholders and the company.[6] The legislative history of the 1984 Act explains and justifies the retention of the proration formula in the following way:

> Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends.[7]

The legislative history also explains that the formula used for purposes of determining the policyholders' share under I.R.C. § 812 is based generally on the proration formula used under the 1959 Act in computing gain or loss from operations.[8] However, whereas a company would want to minimize, and the IRS would want to maximize, the company's share under the 1959 Act in order to minimize or maximize the company's taxable income, under the 1984 Act the goals of the company and the IRS are reversed (the company would want to maximize, and the IRS would want to minimize, the company's share of the tax benefit associated with the DRD). Although the 1984 Act amended the Code by repealing the 1959 Act and adopting a new Part I of subchapter L, the proration provisions of I.R.C. § 812 are based on those of the 1959 Act. Congress intended that the provisions of the Code that are based on the provisions of the 1959 Act were to be interpreted in a manner consistent with the 1959 Act; where provisions of prior law are incorporated in the current Code, that the regulations, rulings and case law under prior law are to serve as interpretative guides to the current law provisions in the absence of contrary guidance in the legislative history of the 1984 Act.[9]

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[3] *See* H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1393 (1984) (1984 House Report); S. Prt. No. 169 (Vol.I), 98th Cong., 2d Sess. 517 (1984) (1984 Senate Report).

[4] *See* 1984 House Report at 1430; 1984 Senate Report at 557; *see* also TAM 9246001 (Oct. 30, 1991) ("proration of tax-exempt interest and the dividends-received deduction prevents a life insurance company from receiving a double benefit by excluding tax-exempt interest from income or deducting a portion of dividends received and then receiving a deduction for an increases on reserves that is partially funded by tax-exempt interest and dividends").

[5] *See* 1984 House Report at 1397; 1984 Senate Report at 521.

[6] *See* 1984 House Report at 1430; 1984 Senate Report at 557. Other corporate taxpayers entitled to the DRD are not subject to proration, even though they also make tax deductible payments to customers, suppliers and counterparties.

[7] 1984 House Report at 1431; 1984 Senate Report at 559.

[8] 1984 House Report at 1430; 1984 Senate Report at 557. The Staff of Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 623 (Comm. Print 1984) (1984 Blue Book) explains I.R.C. § 812 as follows:

> The distinction between taxable investment income and gain from operations has been eliminated. However, the general concept that items of investment yield should be allocated between policyholders and the company has been retained. Under the Act, *the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (i.e., by reference to "required interest").* (Emphasis added.)

[9] 1984 House Report at 1401; 1984 Senate Report at 524.

So, what is the proration formula under the 1984 Act? — I.R.C. § 812(a)(1) defines the company's share as the percentage obtained by dividing the company's share of net investment income for the taxable year by the net investment income for the taxable year. The company's share of net investment income is equal to the excess (if any) of:

(i) net investment income for the taxable year, over
(ii) the sum of policy interest for the taxable year, plus the gross investment income's proportionate share of policyholder dividends for the taxable year.[10]

Although the 1984 Act generally followed the proration rules for computing gain or loss from operations under the 1959 Act, to simplify the computation, I.R.C. § 812(c) statutorily defines net investment income (as 90 percent of gross investment income; but, 95 percent of gross investment income for gross investment income attributable to assets held in segregated asset accounts under variable contracts). The statutory definition of net investment income is used in lieu of determining prior-law investment yield, thus eliminating the prior-law necessity of identifying and allocating expenses to investment rather than underwriting activities.[11]

I.R.C. § 812(b)(2) defines policy interest as the sum of the following four amounts:

(A) required interest (at the greater of the prevailing State assumed interest rate or the applicable Federal interest rate) on reserves under section 807(c) . . . ,
(B) the deductible portion of excess interest,
(C) the deductible portion of any amount (whether or not a policyholder dividend), and not taken into account under subparagraph (A) or (B), credited to –
 (i) a policyholder's fund under a pension plan contract for employees (other than retired employees), or
 (ii) a deferred annuity contract before the annuity starting date, and
(D) interest on amounts left on deposit with the company.

I.R.C. § 812(b)(2) continues with flush language saying, "[i]n any case where neither the prevailing State assumed interest rate nor the applicable Federal interest rate is used, another appropriate rate shall be used for purposes of . . . [determining required interest on reserves]." The last three items counted as part of policy interest are defined in the Code (*i.e.,* "excess interest" is defined in I.R.C. § 808(d)(1)) or are self-explanatory as actual amounts paid or credited during the taxable year to policyholders or customers of the company (*e.g.,* amounts credited to an account value of a pension plan, or interest on deposits). These categories of policy interest were described in the legislative history as expansions on the items to be taken into account for the policyholders' share.[12] By contrast, "required interest," which was a term specifically used and defined in prior law, is not defined in the current Code, nor is it explained in the legislative history of the 1984 Act except by inclusion in a reference to "amounts in the nature of interest" and the statement that the 1984 Act proration formula is based on the formula used under the 1959 Act in computing gains from operations.[13] Thus, we have to look to prior law for the definition of required interest.[14]

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[10] *I.R.C. § 812(b)(1).*

[11] *See* 1984 Senate Report at 558. See also Tech. Adv. Mem. 200038008 (June 13, 2000).

[12] *See* 1984 House Report at 1431; 1984 Senate Report at 558.

[13] *See* 1984 House Report at 1430 and 1431; 1984 Senate Report at 557 and 558.

[14] Rev. Rul. 2003-120, 2003-2 C.B. 1154, considered the issue of what is the amount of reserves used to calculate "required interest" under I.R.C. § 812(b)(2)(A). This ruling recognizes that, although required interest plays a significant part in determining the policyholders' share, I.R.C. § 812(b)(2) provides no guidance regarding the method for calculating required interest. The ruling looks to the legislative history of I.R.C.§ 812 and applies the rules of prior-law I.R.C. § 809(a)(2), concluding that required interest must be calculated using the mean of the amount of the reserves at the beginning and end of the taxable year. Rev. Rul. 2003-120 concludes this, presumably, even though insurance companies may be capable of actuarially determining the actual amount of "interest" credited to the reserves for the taxable year.

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What is "required interest" under prior law? — Generally, under prior-law I.R.C. § 809(a)(2), the 1959 Act defined "required interest" for any taxable year as the sum of the amount of qualified guaranteed interest and the amounts obtained by multiplying —

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c) [the predecessor of I.R.C. § 807(c)], by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

Although that general definition referenced using the rate of interest assumed in calculating reserves, prior-law I.R.C. § 801(g)(5) provided a special rule for determining the rate to be used for required interest in the case of reserves based on segregated asset accounts. Under the special rule, the rate of interest assumed by the company for purposes of computing required interest under prior-law I.R.C. § 809(a)(2) was a rate equal to the current earnings rate of the segregated assets, adjusted for amounts withheld (or retained) from such earnings and not credited to the policyholders' account.[15] Like the Code provisions, the regulations under the 1959 Act, which are to provide guidance for how current law operates, provide general rules for computing required interest (Treas. Reg. § 1.809-2(d)), but provide special rules for contracts with reserves based on segregated asset accounts (Treas. Reg. § 1.801-8(e)). Thus, under both the 1959 Act and the current Code, whether or not a special rule for determining required interest applies depends on whether the required interest computation is with respect to contracts based on segregated asset accounts (*i.e.*, variable contracts).

How does proration apply with respect to variable contracts? — As discussed above, I.R.C. § 812 sets forth the general proration rules for life insurance companies,[16] providing rules for computing the company's share and the policyholders' share of net investment income. However, I.R.C. § 817 sets forth special rules for the treatment of variable contracts.[17] Specifically, I.R.C. § 817(c) provides that —

> . . . a life insurance company which issues variable contracts shall separately account for the various income, *exclusion, deduction,* assets, *reserve* and other liability items properly attributable to such variable contracts.

I.R.C. § 812 and the determination of the policyholders' and company's shares specifically are used to determine the amount of a life insurance company's tax-exempt interest exclusion and dividends-received *deduction.* In explaining these separate accounting rules, the legislative history states that, "[f]or example, with respect to variable contracts, the company's share of dividends received, and the policyholders' share of tax-exempt interest . . . , will be determined with reference to the income and deduction items attributable to the underlying separate account."[18] Again, where the provisions of the Code are based on prior law, in the absence of contrary guidance in the legislative history of the 1984 Act, the regulations, rulings and case law

[15] The fact that prior law provided a special rule for determining required interest apart from the general rule was consistent with how the rules for contracts with reserves based on segregated asset accounts were provided generally. That is, the special rules for such contracts were provided in I.R.C. § 801(g), separate and apart from the general rules for computing taxable investment income under prior-law I.R.C. §§ 804 and 805, and from the general rules for computing gain or loss from operations under I.R.C. § 809. Similarly, under current law, I.R.C. § 817 provides special rules for variable contracts based on segregated asset accounts, which likewise are apart from the general rules set forth in Part I of subchapter L.

[16] There is a provision that applies to non-life insurance companies that reduces a company's losses incurred by 15 percent of the company's tax-exempt interest and dividends qualifying for the DRD, which effectively reduces the tax benefit from such tax-exempt income items by 15 percent. *See* I.R.C. § 832(b)(5)(B). Although the legislative history of the provision refers to it as a "proration provision" and gives the reason for its adoption as being that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax" (H.R. Rep. No. 426, 99th Cong., 1st Sess. 670 (1985)), the provision applicable to non-life insurance companies is not based on a measurement of the investment earnings credited to the loss reserves (*i.e.*, the change in the discounted amount). Unlike the computation of required interest, and the policyholders' share and the company's share under I.R.C. § 812, Congress simply deemed 15 percent to be the appropriate reduction in tax benefits from such tax-exempt income amount for non-life insurance companies.

[17] The I.R.C. § 817(d) definition of "variable contract" mimics the prior-law I.R.C. § 801(g)(1) definition of "a variable annuity contract" and "a contract with reserves based on a segregated asset account," but generalizes the specific requirements of prior law to include variable life insurance as well.

[18] 1984 House Report at 1420; 1984 Senate Report at 546.

under prior law were intended to serve as interpretative guides to the current law provisions.[19]

Keeping in mind the separate accounting requirement for items attributable to variable contracts, under I.R.C. § 812(a) and (b), the company's share with respect to a segregated asset account is the percentage obtained by dividing the company's share of the net investment income of the account by the net investment income (NII) of such account.[20] The company's share of the net investment income is equal to the excess (if any) of (i) net investment income, over (ii) the sum of policy interest plus the gross investment income's proportionate share of policyholder dividends for the year.[21] Although I.R.C. § 812(b)(2) defines policy interest as the sum of four amounts — required interest, the deductible portion of excess interest, the deductible portion of any amount credited to a policyholder's fund under a pension plan contract for employees (other than retired employees) or a deferred annuity contract before the annuity starting date that is not covered by one of the first two amounts, and interest on amounts left on deposit with the company — for variable contracts based on segregated asset accounts, required interest is generally the only amount taken into account in determining the company's share.[22] Thus, the company's share of net investment income attributable to assets held in segregated accounts for variable contracts would be determined simply by subtracting the required interest for such contracts from the statutorily defined net investment income for the accounts.

… the current-law provisions for both proration and for variable contracts are drawn directly from prior law.

How is required interest computed for variable contracts under current law? — As discussed earlier, the current-law provisions for both proration and for variable contracts are drawn directly from prior law. The proration rules are intended to operate like those for determining gain or loss from operations under prior law with a significant simplification of defining net investment as a percentage of gross investment income in lieu of the prior-law investment yield computation. By the same token, the provisions applicable for variable contracts are intended to operate as they had under prior law with two significant changes: (1) the basis adjustment provisions previously applicable only with respect to pension plan contracts were extended to all variable contracts; and (2) diversification requirements for variable contracts were adopted.[23] Consistent with the conclusion that I.R.C. § 812(b)(2) is to be applied as it was under prior law,[24] prior-law I.R.C. § 801(g)(5)(A), which provided a specific rule for determining the "interest rate assumed" (for purposes of prior-law I.R.C. § 809(a)(2)) for contracts with reserves based on segregated asset accounts, should apply for variable contracts accounted for under I.R.C. § 817(c).

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[19] *See* 1984 House Report at 1401; 1984 Senate Report at 524. Note that the separate accounting language of I.R.C. § 817(c) is drawn directly from prior-law I.R.C. § 801(g)(3). Also, I.R.C. § 817(f)(1), like prior-law I.R.C. § 801(g)(2), further provides that, for purposes of defining life insurance reserves, "the reflection of investment return and the market value of the segregated assets account shall be considered an assumed rate of interest." Even though not repeated statutorily under current law, prior-law I.R.C. § 801(g)(5) sets forth a rule for determining, "with respect to life insurance reserves based on segregated asset accounts, . . . the rate of interest assumed by the taxpayer" to be used for computing required interest.

[20] *See* I.R.C. § 812(a). For a segregated asset account, NII is 95 percent of gross investment income (GII) (I.R.C. § 812(c)(2)).

[21] I.R.C. § 812(b)(1).

[22] Variable contracts generally provide that, after certain amounts are withheld by the company for payment to the general account or to third parties (*e.g.*, charges relating to contract guarantees, administration and investment management), all other investment earnings of the segregated asset account are credited to the separate account fo r the policyholder. Generally, the segregated asset account is not available to general account creditors, and vice versa. Variable contracts generally do not receive policyholder dividends or excess interest from the general account (except for any portion of the contract that may be invested in the general account).

[23] *See* 1984 House Report at 1419; 1984 Senate Report at 545.

[24] *See* Rev. Rul 2003-120, *supra*.

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The IRS correctly applied this conclusion in technical advice memoranda addressing how required interest should be computed for variable contracts.[25] Those memoranda recognize that the statutory reference to "another appropriate rate" in I.R.C. § 812(b)(2) is an indication that the greater of the prevailing State assumed rate (PSAR) or the applicable Federal interest rate (AFIR) might not always be the appropriate rate to account for the required interest credited on reserves (*i.e.,* the amount, adjusting for premiums added and withdrawals under the contract, that must be credited to opening reserves to result in the closing reserve amount).[26] One of the technical advice memoranda explains the nature of the required interest computation for variable contracts, as follows:

> [W]e believe that § 812(b)(2)(A)'s reference to "required interest … on reserves under § 807(c)" indicates that a separate account's required interest should reflect the amount of the separate account's net investment income that is deducted by the life insurance company under §§ 805(a)(2) and 807(b) through an increase in reserves. (Emphasis added) In other words, the amount of required interest under § 812(b)(2)(A) should reflect the amount of a separate account's net investment income which, when added to the opening balance of Taxpayer's variable annuity reserves under § 807(c) will produce a sum equal to the closing balance of Taxpayer's closing balance of [sic] variable annuity reserves under § 807(c), after making adjustments for premium contributions and benefit payments during the year, as well as any appreciation or depreciation in the value of the separate account assets.[27]

This explanation recognizes that proration allocates each and every type of investment income for the taxable year (whether fully taxable or tax-favored) between the policyholders and the company and that, conceptually, the policyholders' share attempts to measure the actual investment earnings credited to the contracts and reflected in the reserves for the taxable year. By definition, variable contracts reflect the investment return and market value of the segregated asset accounts in which contract funds are invested. Thus, to the extent variable contract reserves reflect such investment return and market value, the amount of required interest credited to variable contract reserves must be based on a retrospective computation (*i.e.*, that the year-end reserve is the opening balance, plus any added premiums and earnings credited, less any expense charges or amounts paid out from the contract).[28]

The prior-law rules for determining "the rate of interest assumed" for variable contracts and the computation of "required interest" are designed to measure the net investment income actually credited to the variable contract during the taxable year, to the extent that the contract values reflect the investment return and market value of a segregated asset account. Specifically, prior-law directs that the rate of interest assumed for purposes of computing required interest for variable contracts should be —

> . . . the current earnings rate. . . reduced by the percentage obtained by dividing –
>
> (i) any amount retained with respect to all of the reserves based on a segregated asset account by the life insurance company

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[25] Both Tech. Adv. Mem. 200038008, *supra,* and Tech. Adv. Mem. 200339049 (Aug. 20, 2003) considered aspects of the calculation of required interest for variable contracts (*i.e.,* contracts with reserves based on segregated asset accounts), and indicate that it must be determined consistent with prior-law rules as they applied to such contracts, but taking into account changes made to simplify the calculation. Consistent with the rules under prior-law, both look to the return on the separate account assets underlying the variable contracts to determine the rate for calculating required interest.

[26] Specifically, Tech. Adv. Mem. 200339049 quotes the legislative history of I.R.C. § 817's separate accounting requirement (see 1984 House Report at 1420; 1984 Senate Report at 546, *supra*) and states:

> [t]he general definition of required interest under § 812(b)(2)(A) does not apply to a life insurance company's reserves for variable contracts because these reserves are based on the market value and investment returns of the assets in the separate account, rather than a prescribed interest rate under § 807(c) or § 807(d). Therefore, in accordance with the flush language at the end of § 812(b)(2), the required interest under § 812(b)(2) for a life insurance Company's variable contracts must be determined using "another appropriate rate."

[27] Tech. Adv. Mem. 200339049, *supra.*

[28] This is unlike the situation for fixed contracts with benefit guarantees, which do not provide that a portion of actual investment earnings will be credited to the contract values. For fixed contracts, the reserves held by the company are a theoretical estimate of the company's future liabilities under the contract, discounted at an *assumed* rate of interest. Because the opening and closing reserves for fixed contracts are both prospectively computed theoretical estimates, using the same assumed interest rate (and other computational assumptions), the amount of "interest" deemed credited to such reserves can be measured retrospectively by that same assumed interest rate. However, the reserves for such contracts do not reflect actual investment earnings of any designated assets.

from gross investment income . . . on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) [deductible investment expenses] which are attributable to such reserves, by

(ii) the means of such reserves;[29]

Whether used for computing a taxable income base[30] or for prorating tax-exempt income items, the provision quoted above provides guidance for determining the rate at which investment earnings in the separate account has been credited to the policyholders and the amount of such earnings credited (*i.e.,* required interest). In fact, it actually measures the earnings rate required to be credited to the variable contract per the terms of the contract.

Under prior-law I.R.C. § 805(b)(2), the current earnings rate was equal to the company's investment yield for the taxable year divided by the mean of the company's assets at the beginning and end of the taxable year. Thus, beginning with the current earnings rate, the instructions for determining the interest rate assumed for contracts with reserves based on segregated asset accounts can be expressed by the following algebraic formula:

$$\frac{\text{Invest. Yield}}{\text{Mean of Assets}} \text{ less } \frac{\text{Amt. Retained in excess of Invest. Exp.}^{31}}{\text{Mean of Reserves}}$$

Assuming that the mean of the assets equals the mean of the reserves,[32] this formula can be expressed further as:

$$\frac{\text{(GII, less Invest. Exp) less (Amt. Retained, less Invest. Exp.)}}{\text{Mean of Assets}}$$

Which is the same as:

$$\frac{\text{GII, less Invest. Exp, less Amt. Retained, plus Invest. Exp.}}{\text{Mean of Assets}}$$

Or, more simply stated, the interest rate assumed for required interest for contracts based on a segregated asset account was determined by the following formula:

$$\frac{\text{GII, less Amt. Retained}}{\text{Mean of Assets}}$$

Variable contracts by their terms require the company to credit all investment earnings in excess of the charges and expenses that the company subtracts from the segre-

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[29] Prior-law I.R.C. § 801(g)(5)(A); Treas. Reg. § 1.801-8(e)(1).

[30] That is, either the Phase I taxable investment income base or the Phase II gain or loss from operations under the 1959 Act.

[31] Note that, because deductible investment expenses were part of the amount retained and the amount retained also included the profit margin charged by the company, the amount retained would always be in excess of the deductible investment expenses.

[32] Under prior-law, the mean of the assets equaled the mean of the reserves if the segregated asset account contained no seed money (*i.e.,* money unrelated to any contract invested in the account). However, whereas prior-law I.R.C. § 801(g)(3) provided that the company should separately account for various income, exclusion, deduction, asset, reserve and other liability items properly attributable to "such segregated asset accounts," I.R.C. § 817(c) provides such separate accounting for those same items properly attributable to "such variable contracts." If this change is read as indicating that a company should separately account for those items attributable to assets of a segregated asset account that are properly attributable to contract reserves, under current law the mean of reserves in the above formula always will equal the mean of the assets.

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gated assets account. Thus, the guidance provided under prior-law accurately determines the rate at which "interest" is actually credited to a variable contract.[33] This guidance easily can be implemented to reflect current-law simplifications. Given the statutory definition of NII, for purposes of applying current law, the current earnings rate would be NII divided by the mean of the assets in the segregated asset account at the beginning and end of the taxable year. Also, given the definition of NII for segregated asset accounts is 95 percent of GII, then deductible investment expenses would be 5 percent of GII.[34]

What is the reserve taken into account in computing required interest with respect to variable contracts? — As previously discussed, the provisions of both I.R.C. § 812 and I.R.C. § 817 are like their respective predecessors in many ways; Congress intended that these provisions be interpreted consistent with prior law, except to the extent they differed from prior law. The current proration computation is like that used for the computation of gains and losses under the 1959 Act, which provided that required interest was computed based on the interest rate assumed in computing reserves, but I.R.C. § 812(b)(2)(A) specifically says that required interest should be computed at the higher of the PSAR or the AFIR, which are the rates prescribed for life insurance reserves computed under I.R.C. § 807(d)(2). Given that the tax reserve computation rules under I.R.C. § 807(d) do not differentiate between fixed and variable contracts, should a company conclude that it is supposed to compute required interest for variable contracts based on the AFIR (or PSAR) if the company computes CARVM or CRVM tax reserves for such contracts? The short answer is "no."

Although I.R.C. § 807(d) does not differentiate between fixed and variable contracts, I.R.C. § 817 does differentiate variable contracts from fixed contracts by providing special rules. Specifically, the flush language of the definition of "variable contract" contains the following direction —

> Paragraph (3) [the requirement that variable contracts reflect the investment return and market value of the segregated asset account] shall be applied without regard to whether there is a guarantee, *and obligations under such guarantee which exceed obligations under the contract without regard to such guarantee shall be accounted for as part of the company's general account.* (Emphasis added.)

This sentence was added as a technical correction to the 1984 Act. It was adopted as part of the conference report for the Tax Reform Act of 1986 with the following statement —

> i. *Variable contracts with guarantees.* — Certain variable life insurance contracts with guarantees are treated as variable contracts under section 817 with a special effective date.[35]

A more expanded explanation was provided by the staff of the Joint Committee on Taxation, as follows —

> The Act clarifies the definition of a variable contract to provide that variable life insurance or variable annuity contracts with guarantees are treated as variable contracts. In the case of such contracts with guarantees, the requirements relating to investment return and market value of the segregated asset account are applied without regard to whether there is a guarantee. *The Act further provides that obligations under such a guarantee that exceed the obligations under the contract without regard to the guarantee are accounted for as part of the company's general account (i.e., not as part of the segregated account).* (Emphasis added.)[36]

Whereas the conference report contains only a cryptic

[33] The total return for the taxable year for the assets in a segregated asset account will take into account both the investment income return (*i.e.,* dividends and interest) and the market value (*i.e.,* appreciation/depreciation) of assets in the segregated asset account. I.R.C. § 817(a) requires that the company adjust closing reserves for all such appreciation or depreciation for purposes of determining increases and decreases in reserves for the taxable year. This effectively allocates all gains and losses in the value of the assets to the policyholder. The policyholders' share of the actual NII on the assets in the segregated asset account makes up the difference to account for what was credited to the contract reserves to the extent such reserves can be said to reflect investment return and market value of the account.

[34] *See* Tech. Adv. Mem. 200038008, *supra.* This articles does not address whether GII includes/excludes short-term capital gains (*see* Tech. Adv. Mem. 200330002 (Dec. 12, 2002)) or whether the "amount retained" includes certain charges/expenses or should be adjusted if the separate account has no investment expenses (*see* Tech. Adv. Mem. 200339049, *supra*).

[35] H.R. Conf. Rep. No. 841 (Vol. II), 99th Cong., 2d Sess. 848 (1986).

[36] Staff of Jt. Comm. on Tax'n, 99th Cong., 2d Sess., Explanation of the Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation 98 (Comm. Print 1987) (1986 Blue Book for Technical Corrections).

reference to variable life insurance contracts, the explanation of the 1986 Blue Book for Technical Corrections more accurately describes the actual statutory language added to I.R.C. § 817(d). If there was a question of whether a variable contract with guarantees might fail the statutory definition of variable contract when the guaranteed benefits are applicable due to poor investment performance or a drop in market value of the segregated asset account,[37] the first portion of the flush statutory provision addresses this issue. However, the statute goes further and directs the company on how to account, for tax purposes, for the reserves for benefits under the contract that are guaranteed versus not guaranteed.[38] To the extent that the required reserves for a variable contract exceed the benefit amounts not guaranteed in the contract (*i.e.*, the account value or the cash surrender value during the period that surrender charges are applicable), for tax purposes, such amounts are accounted for as part of the general account, leaving only the amount not guaranteed to be accounted for as part of the segregated asset account. Thus, I.R.C. § 817(d) prescribes the reserve amount for which there should be separate accounting under I.R.C. § 817(c) — that is, the reserve amount based on the segregated asset account and not guaranteed under the contract.

As previously discussed, CRVM and CARVM reserve computations are both prospective, theoretical estimates of future liabilities for guaranteed benefits under the contracts, discounted at some assumed rate of interest. For tax purposes, that interest rate is the greater of the PSAR or the AFIR. When the federally prescribed reserve computed under I.R.C. § 807(d)(2) exceeds the net surrender value of a variable contract, it is because the guarantees under the contract are requiring a reserve in excess of that net surrender value (the benefit not guaranteed under the contract). I.R.C. § 817(d) directs the company to split the reserve for the contract so that only the net surrender value (derived from the non-guaranteed account value) is accounted for as part of the segregated account. The required interest for the excess of the CRVM or CARVM tax reserve over the net surrender value, which is accounted for as part of the company's general account, may be determined properly by using the AFIR (or PSAR).[39] For the net surrender value, which is accounted for as part of the segregated asset account, and which reflects the investment return and market value of the segregated asset account (because it is not guaranteed), one has to conclude that required interest properly is computed by reference to the actual investment earnings of the account under the guidance provided by prior law.

Did the NAIC's adoption of Actuarial Guideline 34 (AG 34) change how proration applies for segregated asset accounts? — Prior to 1998, practices varied as to how CARVM reserves were computed for variable annuity contracts that provided guaranteed minimum death

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[37] A classic example of when this could occur would be when a variable life insurance contract has a guaranteed minimum death benefit equal to premiums paid into the contract and the variable account value decreases below that death benefit amount because of a severe down-turn in the market value of the segregated account assets.

[38] There is no reference in the legislative history of the flush language of I.R.C. § 817(d) to statutory accounting principles. Thus, this tax rule might be viewed as operating independently of how the company accounts for variable contract obligations on its annual statements (the Blue Book and the Green Book).

[39] Under the original 1984 Act provision, I.R.C. § 812(b)(2)(A) referred to using the PSAR for required interest. This was changed to "the greater of the PSAR or the AFIR" when similar language was adopted for computing tax reserves under I.R.C. § 807(d)(2) as part of the Tax Reform Act of 1987 (P.L. 100-203, § 10241(a) and (b)(2)(B)(i)-(ii)). As originally drafted, the prescription to use the PSAR for required interest might have been viewed as a necessary complement to the inclusion of the deductible portion of excess interest under I.R.C. § 812(b)(2)(B) because "excess interest" was (and still is) defined as an amount in the nature of interest credited to policyholders "in excess of the interest determined at the prevailing State assumed rate for such contract." I.R.C. § 808(d)(1)(B). For statutory reserves, it might be assumed that a company would use an assumed interest rate that was lower than the PSAR for tax reserves so that the interest amount deemed to be credited to tax reserves would be greater than that determined at the interest rate for statutory reserves. Because statutory excess interest was interest credited to the contract in excess of that deemed credited to the reserves at the assumed rate of interest, excess interest for tax purposes was defined in terms of the interest deemed credited to the tax reserves at the rate assumed for computing tax reserves (*i.e.*, the PSAR). Given the general guidance that the company's share under I.R.C. § 812 should be determined as it was under prior law for the computation of gains or losses from operations, but for the reference to the PSAR in I.R.C. § 812(b)(2)(A), a company may have concluded that required interest for fixed contracts could be computed using the interest rate assumed in determining statutory reserves (*i.e.*, the reserves used under prior-law I.R.C. § 809), potentially resulting in an understatement of the amount of policy interest because the amount of deductible excess interest would have been determined based on using the PSAR. When Congress changed the reference to the PSAR to the greater of the PSAR or the AFIR, it failed to change the definition of excess interest.

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benefits. After AG 34 clarified how the aggregate CARVM reserves for these contracts are to be computed, a life insurance company might hold CARVM reserves for these contracts in its annual statement for its separate accounts (Green Book). Does the fact that a company reports CARVM reserves in the Green Book require the company to report CARVM tax reserves for the segregated asset account and to compute required interest using the AFIR (or the PSAR) instead of another appropriate rate determined under the 1959 Act approach? Again, the short answer is "no." Regardless of how a company reports reserves on its Green Book, the last sentence of I.R.C. § 817(d) directs the company to account for any obligations under a guarantee that exceed the contract obligations that are not guaranteed as part of the company's general account (and not as part of the segregated asset account) for tax purposes. Accordingly, any Green Book CARVM tax reserve in excess of a variable annuity contract's net surrender value should be accounted for as part of the company's general account and not as part of the segregated asset account. In addition to being contrary to the plain language of the Code, the use of the AFIR (or PSAR) to compute required interest for reserves based on segregated asset accounts would be inconsistent with the basic concept of proration and required interest,[40] and with Congress' intent that proration operate generally as it had under prior-law.[41]

Conclusion

Although proration of the DRD for segregated asset accounts has created confusion among tax practitioners and resulted in several technical advice memoranda, the operation of I.R.C. § 812 is really relatively straightforward. Under I.R.C. § 812, another appropriate rate is used to determine required interest for a segregated asset account because neither the AFIR nor the PSAR represents the rate of earnings that is actually credited to the policyholders' account for the taxable year. This is so even if CRVM or CARVM reserves are reflected in the Green Book or used for tax purposes in the general account. Application of the 1959 Act principles provides a formula for determining the interest to be used for required interest for a segregated asset account that allocates investment income to the company to the extent of the retained amount and the remaining investment income to the policyholders. Accordingly, use of the 1959 Act principles, adjusted to reflect the 1984 Act's simplifications for computing NII, appropriately determines the rate at which investment earnings are credited to the policyholders' accounts during the taxable year.

Author's Note — After this article was written, the IRS issued Rev. Rul. 2007-54, 2007-38 I.R.B. __ (Aug. 16, 2007), which concludes that, if the Federally prescribed reserves for the aggregate benefits of a variable contract exceed the net surrender value of the contract, required interest for that contract must be computed using the interest rate prescribed for the reserve computation under I.R.C. § 807(d)(2)(B) (*i.e.*, the higher of the AFIR or PSAR). The ruling acknowledges that certain variable contract reserves are to be accounted for as part of the general account and others as part of the segregated asset account under I.R.C. § 817(d), but concludes that general account and segregated asset account reserves for variable contracts are combined for the life insurance reserve taken into account under I.R.C. § 807(c)(1). Concluding that there is only a single reserve under I.R.C. § 807(c)(1) for a variable contract, the ruling further concludes that there is no separate proration calculation for segregated asset account reserves. As authority for how required interest is computed, the ruling cites Rev. Rul. 2003-120 but not the legislative history of the 1984 Act and the rules for required interest under the 1959 Act that are cited therein. Because Rev. Rul. 2007-54 seems to ignore the separate accounting requirement of I.R.C. § 817(c) for reserves and deductions, and because its application will result in a distorted required interest amount for variable contract reserves, the life insurance industry can be expected to challenge the ruling's conclusions vigorously. ◂

[40] That is, to measure the amount that, when added to opening reserves, results in the closing reserve amount. This position also would be inconsistent with the justification that disallowance of the policyholders' share prevents the company from enjoying a double benefit caused by deductible dividends received amounts being used to fund increases in reserves because the position ignores the fact that the closing reserve amount might be based in part on appreciation in the assets of the segregated asset account and the company receives no increase in reserve deduction for such appreciation in assets. *See* I.R.C. § 817(a)(1).

[41] It would be an unlikely position to have been upheld under prior-law because such a position would arbitrarily maximize the policyholders' share and minimize the company's share. It could have significantly diminished the taxable income base for the company under prior law.

Tax Uncertainty Swirls Around Principles-Based Reserves

by Christian DesRochers

I. Introduction

The treatment of life insurance reserves has always been a significant element in the federal income taxation of life insurance companies. Insurance companies in general and life insurance companies in particular present challenges in the measurement of taxable income. Historically, the tax laws applying to life insurance found in Subchapter L have been among the most complex in the Internal Revenue Code (the "Code"). As life insurers face the same tax rates as other corporate taxpayers, the unique features of life insurance company taxation involve the definition of taxable income.

As work continues on principles-based life insurance reserve requirements (PBR), the federal income tax issues that would result from state adoption of a PBR methodology continue to be unresolved. A key challenge in the transition to a PBR methodology is to determine whether such an approach can coexist with the current structure of the Code as it relates to the deductibility of life insurance reserves. The very elements that make PBR appealing, including the reliance on actuarial judgment and the use of more sophisticated financial modeling tools, create challenges in a tax valuation system. While some discussions have occurred between the industry and the Treasury, it is unlikely that definitive guidance will be forthcoming until the regulators finalize the proposed PBR methodology. However, while the resolution remains unclear, recent discussions and papers published in *Taxing Times* and the *Actuarial Practice Forum,* the on-line journal of the Society of Actuaries, have identified several issues related to the tax treatment of PBR.[1]

In the May 2007 issue of the *Actuarial Practice Forum,* Doug Hertz and I co-authored an in-depth analysis of the background and implications of principles-based reserves on the taxation of life insurance companies entitled "Treading into the Thicket: Federal Income Tax Implications of Principles-Based Reserves. " Based on the analysis presented in that paper, this article considers three issues from the viewpoint of tax policy:

1. How are the amounts of the life insurance reserve deduction determined?
2. What is the effect of the life insurance reserve system on the measurement of taxable income?
3. What questions are raised by the transition to a PBR reserve system as it relates to federal income tax issues?

II. The Deduction of Life Insurance Reserves

Although the tax rules applicable to life insurance companies have gone through significant changes over the years, it has been a fundamental concept that a life insurer should not be taxed on income that is set aside to meet future contingent benefit liabilities. The ability of life insurance companies to reflect reserves in determining taxable income is perhaps the defining feature of life insurance company taxation. Under the 1984 Tax Act, life insurance companies are permitted to deduct the increase in a "federally prescribed reserve" (FPR), enabling the insurer to offset premium income by some measure of their expected future benefits. Under current

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[1] These include "The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System," Joseph F. McKeever, III, John T. Adney and Lori A. Robbins, *Taxing Times,* May 2006; "Treatment of Taxes in Principles-Based Reserves," Edward L. Robbins, *Actuarial Practice Forum,* October 2006; "Actuary/Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM," Peter Winslow and Edward Robbins, *Taxing Times,* February 2007; and "Actuary/Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II)," Peter Winslow and Christian DesRochers, *Taxing Times,* May 2007.

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law, section 807(c)(1) allows a deduction for life insurance reserves as defined in section 816(b)(1), in amounts described in section 807(d). Section 816 defines life insurance reserves as amounts "which are set aside to mature or liquidate . . . future unaccrued claims…" If more than 50 percent of its total reserves qualify as life insurance reserves under section 816(b), then the insurance company is a life insurance company.

Since the inception of the income tax, the reserves recognized for tax purposes have been based on statutory reserves, as accounting methods for state regulatory purposes generally apply to insurance company taxation to the extent they are not inconsistent with federal accounting rules. However, state valuation laws have as their purpose the protection of the solvency of the insurance company and are primarily focused on the balance sheet, not period-by-period income. The operation of the statutory reserve system is neither intended nor designed to reflect accurately the economic income flowing through a life insurance company. Therefore, not every item allowed or required by state authorities as a reserve is necessarily deductible.

Under the Code, the deduction of reserves is generally limited to insurance companies. That is, one of the consequences of the accrual method of accounting is that taxpayers generally are not entitled to currently deduct amounts set aside to cover anticipated future expenses. For non-insurance company taxpayers, the Supreme Court has noted that a "reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction."[2] In fact, reserve accounting is generally inconsistent with the goal of the tax system, which is the generation of tax.

The tax rules applied to life insurance reserves have been a constant source of tension between taxpayers, who seek to maximize reserve deductions, and the tax authorities, who are concerned with generating tax revenues. Much of the litigation that has arisen over the years with respect to life insurance reserves deals with the definition of what items can be considered as deductible reserves, given that the general rule in the Code is to disallow reserve deductions. Ultimately, the definition was codified and is now found in section 816. What emerged was a definition that focused on the "scientific" actuarial present value of amounts "reserved" from premiums for the payment of future benefits.

Congressional tax writers and others have long recognized that the problem in determining an equitable tax base for life insurance companies was related to reserve deductions. Tax authorities came to see deductions for state law–based additions to reserves as exceeding the amounts economically necessary to cover expected future liabilities, resulting in a distortion of income and a significant deferral of tax. The congressional intent to allow a deduction for no more than "economic" reserves first manifested itself in the 1984 enactment of section 807(d), which sets forth specific rules for computing the deductible amount of life insurance reserves.

It is clear that it is in the interest of the Treasury for life insurance companies to be taxed under the life insurance company provisions of Subchapter L. Thus, some accommodation must be reached so that the introduction of PBR does not cause life insurers to lose their qualification as life insurance companies under section 816. At the same time, almost 100 years of precedent would seem to weigh against the full deduction of a comprehensive principles-based reserve, which includes not only specific assumption margins, but also reserves for future expenses and non-guaranteed benefits. How that conflict is resolved will be critical to the federal income tax treatment of PBR.

III. Reserves and the Measurement of Taxable Income

An insurance reserve system has two functions, which often conflict. The first is to ensure that sufficient funds are set aside so that the insurance company can meet its obligations to its policyholders. The second is to control the emergence of profit, and thereby the growth of surplus. The objectives and operation of a reserve system will change depending on the relative importance of the two functions. For example, a solvency-based system may be better served when valuation assumptions are changed to reflect current conditions, whereas an earnings-based system generally looks to more stable valuation assumptions. Reserve systems are a function of the accounting system on which they are based. The actual cash flows from a block of life insurance policies are independent of the policy reserve. Therefore, the basis of valuation does not directly affect the value of the surplus that will ultimately accrue, but merely the incidence of the emergence of surplus. In general, a reserve system is at its heart an accounting device that adjusts the flow of accounting income; that is, in general terms, the policy

[2] United States v. General Dynamics, 481 U.S. 239, 246 (1987).

reserve system can be considered a timing mechanism, which determines the emergence of reported earnings on the books of a life insurer. [3]

In general, a reserve system is at its heart an accounting device that adjusts the flow of accounting income …

Under the current PBR proposal, the minimum reserve as of the valuation date equals "The Stochastic Reserve but not less than the Deterministic Reserve, where the Reported Reserve is calculated as the Deterministic Reserve plus the excess, if any, of the Stochastic Reserve over the Deterministic Reserve." The Deterministic Reserve is a seriatim (policy-by-policy) reserve using a single scenario and a set of Prudent Best Estimate assumptions, which is no less than the policy cash surrender value (or zero, for a non-cash value product). The Stochastic Reserve equals the amount determined by applying a prescribed contingent tail expectation (CTE) level to a range of Scenario Reserves over a broad range of stochastically generated scenarios and Prudent Best Estimate assumptions for all assumptions not stochastically modeled. Scenario Reserves are the reserves for all policies on an aggregated basis for a given scenario.

The proposed PBR methodology is not a net premium valuation method, but instead is a gross premium reserve (GPR), equal to the present value of future benefits (including non-guaranteed benefits) and expenses (excluding federal income tax) less the present value of future gross premiums. Under a gross premium approach, reserve assumptions are determined for all material risks, including not only mortality and interest, but also expense, lapse and premium payment pattern. Both the stochastic reserve and deterministic reserve calculations require the use of cash flow models, which project the premiums, benefits, expenses and other applicable items to be used in the reserve calculations. In addition, the model is to reflect the impact of all material product features, including both the guaranteed and nonguaranteed elements of the policies.

As a result, the emergence of profit under the proposed system is fundamentally different from that under a net level reserve system. A key characteristic of the GPR system is that the present value of future profits is recognized at issue.[4] That is, the initial valuation of a block of policies "capitalizes" the difference between the pricing assumptions and the valuation assumptions, while subsequent valuations capitalize the difference in valuation assumptions: that is, the system effectively "fronts" the present value of gains and losses.

Any tax system is effectively defined by the various accounting rules that are used to determine the various elements of taxable income. For life insurance companies, the reserve deduction is a key element in computing taxable income. Were PBR to be used as the basis for tax reserves, a key question is whether the pattern of income that emerges is appropriate to determining year-by-year taxable income. Determining the answer may well require significant modeling not only of the effect of the change in reserves, but also the income effects, including both the initial and subsequent valuations.

IV. Transition to a PBR System

There are several questions for which guidance is needed to clarify the tax issues created by a transition to a PBR system for statutory reserves. While these are discussed in more detail in the paper Doug Hertz and I authored, a summary of the issues follows. Answers to these questions are needed so that taxpayers will have some indication of how principles-based reserves interact with current tax law.

Do PBR reserves qualify as life insurance reserves under section 816 to determine qualification as a life insurance company?

The answer isn't clear. It could be argued that PBR satisfy at least some (or all) of the section 816 criteria. They would be held with respect to the required types of contracts, and they would be required by law. They are based on interest and mortality. On the other hand,

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[3] When the reserve calculation involves net premiums of uniform amounts and is based on the mortality and interest assumptions used in computing the net premium, the resulting reserve is known as a net level premium reserve. One characteristic of a net premium valuation is that the retrospective reserve is at all times equal to the prospective reserve. *See* CHESTER W. JORDAN, JR., SOCIETY OF ACTUARIES' TEXTBOOK ON LIFE CONTINGENCIES, 101 (2nd Ed. 1967).

[4] For example, an embedded value calculation, which has many elements in common with a gross premium valuation, is intended to show the present value of all amounts that will be distributable to shareholders based on best-estimate assumptions. The present value of gains or losses from the sale of a block of policies will be recognized in the year in which the policies are sold.

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given the inclusion of expenses and non-guaranteed benefits, the history of the development of the technical definition of life insurance reserves, and the Service's rulings position with respect to GPR, the Treasury may find it difficult to simply accept that either the deterministic or the stochastic elements of the PBR will qualify in their entirety as life insurance reserves under section 816.

What is the definition of CRVM under section 807 as it applies to principles-based reserves?

In reality, it may not matter. For life insurance contracts, the tax reserve method is "CRVM in the case of contracts covered by CRVM." For other contracts, the method is "the reserve method prescribed by the National Association of Insurance Commissioners [NAIC] which covers such contract (as of the date of issuance)." Thus, it may be the prescription of the method by the NAIC and not the label applied that may be relevant. In practice, characterization of PBR as other than CRVM may make it easier for Treasury to accept all or some of the elements of PBR to be treated as FPR under section 807(d).

What effect does the inclusion of factors other than interest and mortality have on the status of the reserves? What is the effect of the introduction of nonguaranteed elements and expenses?

One view is that tax reserves are fully defined by the federally prescribed reserve in section 807(d). Another view is that courts have generally permitted factors other than interest and mortality to be recognized in the calculation of life insurance reserves, but have tempered that view by adding: "We do not believe that Congress intended to permit an insurance company to exclude any amount it saw fit from its taxable income by creating reserves."[5] Thus, some factors, including lapse rates, may be permissible in the calculation of tax reserves, but this is likely to be tempered by the admonition concerning the reasonableness of the assumptions. The use of additional factors in the calculation of tax reserves may also result in differences in reserve deduction among taxpayers, depending on the assumptions. At a minimum, guidance is needed from Treasury as to what additional factors may be considered and what limitations may be placed on the factors, in establishing tax reserves.

What is the effect of company-specific mortality assumptions?

Under the PBR Model Regulation, company-specific mortality is used in reserves to the extent that it is credible. On its face, this approach is inconsistent with the current view of the Internal Revenue Service, as it has been expressed in Technical Advice, which interprets the statute as only permitting adjustments to the prevailing table for "risks not otherwise taken into account." Further, the development of multiple mortality tables may cause the Treasury to require the use of the table that produces the lowest possible reserve, even though that table may not be used in statutory reserving.

What is the prevailing state assumed rate?

In determining the federally prescribed reserve for a life insurance contract, section 807(d)(4) mandates an interest rate, determined at the time the contract is issued, equal to the greater of (1) the AFIR or (2) the "prevailing State assumed interest rate" (PSR). The AFIR is published annually by the IRS, computed as a five-year average of the federal mid-term rates. The PSR is the "highest assumed (valuation) interest rate permitted to be used in computing reserves for the contract under the insurance laws of at least twenty-six states at the time the contract is issued." The use of discount rates based in projected asset returns and projected interest scenarios may be difficult to reconcile with the AFIR/PSR statutory regime.

Are the stochastic reserves likely to be considered nondeductible "solvency" or contingency reserves?

Historically, deductions have been allowed for "technical actuarial reserves" and not "solvency reserves." Not every reserve required or allowed by state regulatory authorities is deductible. Stochastic reserves are computed by simulating possible future economic scenarios, each of which provides a different yield curve of future interest rates. This creates two issues: (1) tax reserves are based

[5] Union Mutual Life Insurance Company v. United States of America, 570 F.2d 382, 397 (1978).

on an assumed interest rate not a distribution of rates; and (2) values based on a CTE methodology capture the "tail" of the distribution, not the expected value. Moreover, uniformity by company has been a long-term goal of the various methods of reserve taxation.[6] The description of the stochastic element of the reserve might lead some to conclude that it was a contingency reserve or "solvency reserve," but not a life insurance reserve.

What are the implications of including margins in the valuation assumptions?

From a tax perspective, margins are problematic in two respects. First, as previously noted, the "best-estimate" assumptions represent the expected value of policy benefits and expenses, while the effect of the margins is to create a "contingency reserve," which has historically not been deductible. Second, under the gross premium valuation method, the effect of the margins is to create an immediate deduction (at issue) for the difference between the "best-estimate" reserves and the reserves with margins included.

How will reserve increases and decreases that result from changes in assumptions be treated?

Section 807(f) addresses the treatment if there is a change in basis of computing reserves. In general, the total effect of the basis change (*i.e.*, the reserve increase or decrease) is spread over 10 years, based on the difference in the reserves between the reserves on the old basis, and those on the new basis, determined at the end of the current tax year. The effect of the dynamic valuation aspects of PBR on the "10-year spread" will need to be clarified, or life insurance companies may find themselves in a constant 10-year spread position. Some people have argued that if reserves are computed using dynamic assumptions, then a change in assumptions does not require a 10-year spread. The implication of that argument is any strengthening or weakening of reserves resulting from a change in assumptions would flow into income in the year the change occurs.

V. Conclusion

As the discussions of principles-based reserves continue, two fundamental questions may to a large degree determine the tax treatment. First, what makes sense from a tax policy viewpoint? Second, what can be reconciled with the technical requirements of sections 807 and 816 of the Code? Under the 1984 Act, tax reserves are based on statutory reserves adjusted to meet the requirements of section 807. Before life insurance companies can determine their tax reserves under a PBR system, they must know what adjustments are needed from statutory to tax. When and how the Treasury chooses to answer these questions will be critical to the determination of deductible reserves under a PBR system.

Before life insurance companies can determine their tax reserves under a PBR system, they must know what adjustments are needed from statutory to tax.

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[6] For example, section 818(c), enacted in the 1959 Act, was arguably an effort to provide an equivalent reserve deduction among companies. It permitted companies holding modified reserves an approximate recalculation to a net level basis in determining deductible reserve amounts.

Is Homogeneity Required to Qualify as Insurance?

by Peter H. Winslow, Susan J. Hotine and Gregory K. Oyler

Since the income tax was enacted, the IRS and tax practitioners have struggled with the fundamental question: what is insurance? The term is not defined in the Internal Revenue Code except indirectly in I.R.C. § 7702 which defines a life insurance contract. Instead, Congress has deferred to the courts to develop the criteria to determine whether an arrangement will be treated as insurance for tax purposes.

In the context of captive insurance companies, the Tax Court has developed a three-pronged framework for a facts-and-circumstances analysis in determining whether an arrangement is insurance for tax purposes: (1) an insurance transaction must involve "insurance risk"; (2) "insurance" is to be defined in its commonly accepted sense; and (3) insurance involves risk shifting and risk distribution.[1] The courts have characterized the elements of this framework not as independent or exclusive, but as informing each other and, to the extent not fully consistent, confining each other's potential excesses.

Under the Tax Court's test, the existence of "insurance risk" is a threshold requirement in determining whether insurance exists for tax purposes. Generally, insurance risk is present if an insured faces some hazard, and an insurer accepts a premium and agrees to perform some act if or when the loss event relating to the hazard occurs.[2] The focus is on the nature of the losses covered by the policies and the designated responsibility for payment of those losses. In general, this part of the test probably will be met if: (1) the types of risk insured are risks for which commercial insurance companies typically issue insurance policies; and (2) the terms of the policy do not convert the coverage to a mere investment risk, a loan, a mere claims-servicing arrangement, or some other arrangement that does not involve insurance risk.

The second factor in the Tax Court's test is that insurance arrangements must comport with commonly accepted notions of insurance to be treated as insurance. Significant factors in this determination include whether: (a) the insurer is organized and operated as an insurance company; (b) the insurer is regulated under insurance law; (c) the insurer is adequately capitalized; (d) premiums are negotiated at arm's length; and (e) policies issued by the company are valid and binding.[3]

The third factor is that an insurance transaction generally must involve risk shifting and risk distribution to be treated as insurance for tax purposes.[4] Under the case law, the risk shifting inquiry requires an examination on one level of the terms of the policy to determine whether it transfers an insurance risk from the insured to the insurer. Further, there must be an examination on a second level whether, under the economic and other conditions outside the policy, the true burden of economic loss has been shifted to the insurer in the event of adverse claims.[5]

Whether an arrangement transfers risk for book purposes probably is an important aspect of the test, although it is doubtful whether the IRS would consider it deter-

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[1] *See AMERCO v. Commissioner,* 96 T.C. 18 (1991), *aff'd,* 979 F.2d 162 (9th Cir. 1992); *Harper Group v. Commissioner,* 96 T.C. 45 (1991), *aff'd,* 979 F.2d 1341 (9th Cir. 1992); *Sears, Roebuck and Co. v. Commissioner,* 96 T.C. 61 (1991), *aff'd in part and rev'd in part,* 972 F.2d 858 (7th Cir. 1992).

[2] *See AMERCO,* 96 T.C. at 38-39.

[3] *See Harper,* 96 T.C. at 60.

[4] *Helvering v. Le Gierse,* 312 U.S. 531, 539 (1941).

[5] See the related discussion in *Taxing Times* Tidbits "IRS Rules that Retroactive Reinsurance Is Not Reinsurance for Tax Purposes."

minative for tax purposes.[6] The applicable financial accounting standards for determining whether risk is transferred from an insurer to a reinsurer can be found in *Statement of Financial Accounting Standards No. 113* (FAS 113), paragraphs 9, 11, and *Statement of Statutory Accounting Principle No.* 62 (SSAP 62). Under FAS 113, for a policy to qualify for reinsurance accounting treatment, it must transfer insurance risk from an insurer to a reinsurer. To satisfy this requirement, (i) the reinsurer must assume significant insurance risk with respect to the underlying contracts so that it is *reasonably possible* that the reinsurer may realize a *significant loss* from the transaction, or (ii) it must be evident that the reinsurer has assumed substantially all of the insurance risk with respect to the underlying insurance contracts. As a rule of thumb, the reasonable-risk-of-significant-loss standard generally has been understood to require at least a 10-percent chance of a 10-percent loss ("10-10 Test"). This is usually interpreted to mean that the *underwriting loss* at the 90th percentile must be at least 10-percent of the ceded reinsurance premiums (*i.e.,* the ultimate incurred loss is expected to be 110 percent of premiums), where both underwriting loss and premiums are stated as present values.[7]

Under FAS 113, for a policy to qualify for reinsurance accounting treatment, it must transfer insurance risk from an insurer to a reinsurer.

Insurance arrangements also must involve risk distribution to be treated as insurance for tax purposes. The Tax Court has described risk distribution as follows:

> Under principles of the insurance industry, risk transfer and risk distribution occur only when there are sufficient unrelated risks in the pool for the law of large numbers to operate. As the number of unrelated risks is increased, protection is improved against the chance that the severity and number of harmful events will be spread over time or in other ways in groupings disproportionate to the overall risk. *That is, with an increasing number of ventures in a combined pool, the unusually favorable and unusually harmful experiences tend to stay more nearly in balance.* * * *[8]

Factors that the IRS generally examine to determine whether risk distribution is adequate typically relate to the number of insureds, the existence of unrelated insureds, concentrations of insureds, concentrations of risks, and, recently, the homogeneity of risks. In the context of captive insurance companies covering only brother-sister affiliated company risks, cases finding adequate risk distribution have generally involved large numbers of insureds.[9] On the other hand, risk distribution has been found generally adequate in cases involving a large number of *unrelated* insureds.[10]

There also has been some guidance from the IRS on this issue. In Rev. Rul. 2002-90, 2002-2 C.B. 985, the IRS ruled that amounts paid for professional liability coverage by 12 operating subsidiaries to an insurance subsidiary of the common parent were deductible as "insurance premiums" under I.R.C. § 162. The IRS concluded risk distribution was adequate where together the 12 subsidiaries had a significant volume of independent,

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[6] *See* FSA 200209017 (Nov. 26, 2001).

[7] In August 2005, the Casualty Actuarial Society published a paper that proposed an "Expected Reinsured Deficit" as an alternative to the 10-10 Test. A working group of the American Academy of Actuaries followed suit with a report that agreed that there could be other acceptable risk transfer tests other than the 10-10 Test. The Canadian Institute of Actuaries also has formed a task force that is expected to issue a paper that will consider risk transfer and related issues.

[8] *Gulf Oil Corp. v. Commissioner,* 89 T.C. 1010, 1025-1026 (1987) (fn. ref. omitted), quoting from R. Keeton, Insurance Law Basic Text 6-7 (1971) (emphasis in original).

[9] *See, e.g., Kidde Industries, Inc. v. U.S.*, 40 Fed. Cl. 42 (1997) (risk distribution where workers' compensation, automobile, and general liability risks of over 100 subsidiaries were involved); *Humana, Inc. v. Commissioner,* 881 F.2d 247 (6th Cir. 1989) (risk distribution where risks of several dozen subsidiaries operated even more hospitals); *Harper, supra* (30 percent of premiums attributable to 2500 insureds provided sufficient pooling for risk distribution).

[10] *See, e.g., AMERCO, supra,* (unrelated insurance of over 50 percent of insurer's business provides adequate risk distribution, given diverse and multifaceted character of risks); *Harper, supra,* (unrelated insureds comprising 30 percent constitute sufficient pooling for risk distribution); *but cf. Gulf Oil, supra* (no risk distribution where less than 2 percent of a captive insurance company's business comes from unrelated insureds).

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homogeneous risks, and no subsidiary had less than five percent or more than 15 percent of the total risk insured by the captive. The captive retained all the risk that it insured from the subsidiaries. Other factors present in the ruling included a valid non-tax business purpose, adequate capital with no parental or related-party guarantees, a captive that was fully licensed in the state of its formation and the other states in which it conducted business, arm's-length premiums established according to customary industry rating formulas, and no loans by the captive to the parent or its sister operating subsidiaries.[11] In FSA 200202002 (Sept. 28, 2001), the IRS concluded that risk distribution was unlikely where insurance arrangements involved the risks of only two sister companies, with one company accounting for 86- to 88-percent of the captive's premium income and the vast majority of the risks covered.[12]

Although homogeneity of risks is not often mentioned by the cases as supportive of risk distribution, it seems to be an important factor for the IRS. In Notice 2005-49, the IRS requested comments on the factors to consider in the definition of insurance and asked for comments regarding "the relevance of homogeneity in determining whether risks are adequately distributed for an arrangement to qualify as insurance."[13] The importance of homogeneity is unclear, however. Where a larger group of risks is similar, the law of large numbers may operate to reduce the risk that multiple claims will deplete the company's capital. In this sense, homogeneity can be said to enhance risk distribution. On the other hand, a concentration of similar risks could have the opposite effect making diversification of risk desirable. For example, a combination of an adequate pool of one type of risk (*e.g.*, workers' compensation) with an adequate pool of another risk (*e.g.*, property) can provide more risk distribution than a larger, separate pool of either type of risk alone.

On April 13 and June 5, 2007, the IRS released PLR 200715012 (Jan. 11, 2007) and PLR 200724036 (March 20, 2007), each of which concludes that the I.R.C. § 501(c)(15) tax exemption for small nonlife insurance companies does not apply because the contracts issued by the taxpayer in question were not insurance. The rulings specifically include discussions of homogeneity of risks as being relevant to the determination of whether the contracts issued by the company provide sufficient risk distribution to qualify as insurance for tax purposes.

For the risk distribution discussion, PLR 200715012 focuses on the fact that the company issued 14 insurance contracts in one year, and those same contracts plus two reinsurance contracts covering four contracts in another year. Although the insureds and ceding company were all unrelated to the owner of the insurance company, each of the insureds was an individual member of the same family, or was a corporation owned by the same family. This also was true for the ultimate insureds in the reinsured contracts. For the directly issued contracts, five types of insurance contracts were issued—personal disability coverage (eight contracts), corporate general liability coverage (one contract), corporate business owner's coverage (two contracts), personal property coverage (two contracts) and corporate directors and officers coverage (one contract). The ruling concludes that these facts do not result in insurance because "[t]here is no statistical phenomenon known as the 'law of large numbers' among each different type of insurance. There is no risk distribution of any of the five policies to help cover any claims that could be filed."

To reach its conclusions in PLR 200715012, the IRS might have relied solely on its alternative analysis that investment activities, rather than insurance activities, predominated. Instead, the IRS provides the analysis that "[i]f we consider each individual type of policy separate, because they are not homogeneous, it is the Service's position that there is not adequate risk distribution." However, the IRS cites no authority for its apparent conclusion that the application of the law of large numbers requires homogeneous risks. Although there seemed to be adequate risk shifting, the IRS said that, without adequate risk distribution, the contracts did not qualify as insurance. The IRS' position as stated introduces a new element—whether the risks are homogeneous—to be considered in determining "what is insurance" for tax purposes.

PLR 200724036 involved an insurance company that was created to provide medical malpractice insurance. In

[11] *See also* Rev. Rul. 2005-40, 2005-2 C.B. 4, Situation 2 (risk distribution not achieved where one insured with significant independent, homogeneous risks provided 90 percent of the total amounts earned and 90 percent of total risks assumed by the unrelated insurer); Rev. Rul. 2002-89, 2002-2 C.B. 984, (risks from unrelated parties representing 10 percent of total risks borne by subsidiary insufficient to qualify arrangement between parent and subsidiary as insurance).

[12] *See also* TAM 200323026 (Feb. 7, 2003) (limited risk distribution found where two-thirds of premiums covered pollution risk at a few locations of one insured and remaining third covered relatively small number of operations of five insureds).

[13] *See also* Rev. Rul. 2005-40, *supra*.

2005, the company issued six insurance contracts: two policies providing medical malpractice coverage for the company's owner and her husband, one policy providing various commercial coverages for a local coroner, and three policies providing commercial flood insurance coverage for the owner's and husband's businesses, and for an unidentified company. The IRS concluded that there were too few risks to satisfy the risk distribution requirement, noting also that the lack of homogenous risks "further diluted the distribution within the small number of insureds." The IRS went on to describe risk distribution in terms of the availability of capital to pay claims. The ruling concludes that the company's risks were spread over too many different lines of high-risk coverage increasing the likelihood that a single costly claim would exceed the company's ability to pay the claim.

With PLR 200715012 and PLR 200724036 the IRS already might have answered, at least in part, the question raised by its request for comments in Notice 2005-49: under what circumstances should the IRS rule that insurance of unique risks does not qualify as insurance because there are no similar risks being insured? According to the rulings, the lack of homogeneity of risks can be an important factor in concluding that risk distribution is not present. However, the rulings do not attempt to address the more fundamental questions of what are homogeneous risks and when will this factor govern the outcome. It appears that the answer lies in an analysis of whether the principle of the "law of large numbers" has come into play. Similarity of risks should not be an absolute requirement under the IRS' test, however, if an insurance company were to insure a large number of disparate risks and the company's capital is sufficient to pay claims as they occur. Unfortunately, the rulings provide little guidance as to where the line will be drawn so that the law of large numbers will be considered to apply to insurance of unique risks.

Editor's Note: Can any readers shine some light on this question? Is there actuarial literature that addresses the relationship between homogeneity and level of risk? *Taxing Times* would like to hear from you on this question.

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The Taxation Section and the SOA Exam Structure

by Kory J. Olsen

Taxes are the single largest expense of an insurance company. They cut across all practice areas and impact the work of all actuaries. Actuaries need to understand taxes and their impact.

A high priority of the Taxation Section is tax education. The section has put together superb seminars and sessions at SOA meetings to provide tax education to actuaries. However, a key to educating future actuaries on taxes is to include a sufficient amount of tax content on the actuarial exams and modules.

Exam Review

In late 2005 the section council expressed concerns that a sufficient amount of taxation material be included in the new SOA syllabus. Discussions were held with SOA staff and some volunteer leaders. It became clear that the place to start was with the Learning Objectives/Outcomes and Syllabus Resources for the FSA-level exams.

During 2006, the section council members reviewed those learning objectives and outcomes and provided comments to the leaders indicating where the objectives should contain more or different tax topics. The exams reviewed included two retirement exams, two group and health exams, three finance/ERM/investment exams and two individual insurance exams.

Module Involvement

The SOA exam structure also contains online modules that include an end-of-module exercise. The FSA modules are intended to cover topics that are important for the student to know and be aware of, but not necessarily at the level of the detail covered by the exams. It is also meant to be a reference source to the student. The section's involvement in the modules has come from two directions. For some modules, the council was approached by the leader of the module to solicit volunteers to build the tax content. For other modules, the council approached the leader of the module and requested that taxes be included in the content. Following is a description of the modules where the section has been most involved.

Regulation Module

The Regulation Module is in the Individual Life & Annuity Track and has a large dose of taxes. This module covers both policyholder and company tax from both the U.S. and Canadian perspectives. The Taxation Section has been fully involved in developing the tax material and making the module operational.

Financial Reporting and Operational Risk Module

The Financial Reporting and Operational Risk Module is in the Finance/ERM Track. This module covers company tax from both the U.S. and Canadian perspectives. Taxes are allocated a smaller amount of time in this module than in the Regulation Module. This module focuses on the larger drivers of company tax.

Advanced Investment Topics Module

The Advanced Investment Topics Module is in the Investment Track. Until now, there has not been any tax material in this track. The council is working with the leaders of this module to include a discussion of taxes as it relates to investments.

Ongoing Involvement

The section will continue its involvement with the exams and modules. The new exam structure is expected to be fully in place with all modules launched by the end of the year. The system is set up to receive student feedback and make some changes as a result of the feedback. Along with the changes for feedback, the modules will undergo a full review one to two years after launch.

The section will maintain its involvement in the exam process to ensure that sufficient and appropriate tax material is covered on the exams. If you are interested in participating in any part of the process, please contact me or any other council member.

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T^3: *Taxing Times* Tidbits

ACLI Continues Dialogue with Treasury and IRS on AG VACARVM

by Bill Elwell

The American Council of Life Insurers (ACLI) continues its contact with the Treasury Department (Treasury) and the Internal Revenue Service (IRS) relating to the National Association of Insurance Commissioners' (NAIC) exposure draft of "Actuarial Guideline VACARVM – CARVM for Variable Annuities Redefined" (AG VACARVM). Following an initial meeting with Treasury and IRS officials earlier this year, ACLI submitted a letter that: (i) explained the differences between the proposed reserving method and current reserving methods; (ii) described the NAIC's process and schedule for approval of the proposal; and (iii) discussed the significant federal income tax implications of this new reserving method. ACLI also included with the letter valuable background information on the development of AG VACARVM, and a glossary of terms—organized by topic—that further elaborates on some of the terminology.

ACLI contact with the Treasury and the IRS has focused on fully informing them of the NAIC's project to modernize the reserving methodology for variable annuities as it goes forward and highlighting the aspects of AG VACARVM that have potentially significant ramifications under section 807 of the Internal Revenue Code,[1] because the life insurance industry will need published guidance soon after the proposed statutory reserve methods are adopted.

ACLI has emphasized the industry's need for the Treasury and the IRS to address first the reserve modernization efforts for variable annuity contracts before turning to any new methodologies proposed for life insurance contracts, because the NAIC's variable annuity efforts are farther along in their development than the modernization efforts relating to the reserving methodology for life insurance contracts. Because the issues presented in both these modernization efforts are similar, ACLI expects that the knowledge the Treasury and the IRS gather in considering the impact of AG VACARVM will inform the decisions they must make when considering the more sweeping changes of a principles-based approach for calculating statutory reserves on life insurance contracts.

ACLI anticipates participating in additional meetings on the subject and continuing to work through the issue with both the Treasury and the IRS.

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Do SSAP + PBR = IAS?

by J. Howard Stecker

One constant in today's world is change. Technology, ideology, politics, convergence of financial markets, health care—no matter what the topic—there is change. It should therefore, come as no surprise that the world of accounting is also changing. We have seen a trend towards more reporting guidance from FASB, SEC and

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[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

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their staff and have witnessed the codification of Statutory Accounting Principles at the turn of the millennium … and now its creep towards GAAP. What we have not seen, however, is a broad based, fundamental shift in the basis of financial reporting that state regulators use in order to measure solvency and capital requirements. Well, the wait may just about be over.

One only has to look back a decade to realize that a significant segment of the insurance industry utilized statutory accounting as its basis of accounting to regulators and external sources. However, FASB changed all of that with FIN 40 in April 1993 requiring mutual insurance companies to follow generally accepted accounting principles (GAAP), not statutory accounting principles (SSAP) if they want their auditors to provide an opinion that shows their financial statements are prepared in conformity with GAAP. So today, we have SSAP for regulatory reporting purposes and we have GAAP for external public reporting. Sounds manageable. However, the world is larger than the United States and the U.S. insurance industry is slowly taking on a more global look. So it is of no surprise the U.S. insurance regulators are paying more attention to what their counterparts in other countries are doing to insure solvency of their domestic insurance industries. Moreover, the U.S. life insurance industry's current efforts to implement principles-based reserve (PBR) methodologies are more in line with International Accounting Standards (IAS) than it is with current GAAP or SSAP.

All of this change seems to be the beginnings of what may be an irreversible trend—convergence of U.S. regulatory accounting with IAS. Why not? GAAP has a current project underway to do the same thing. Further, at the June 2007 quarterly NAIC meeting, the PBR executive task force adopted principles that provides future solvency and capital requirements should be consistent with International Association of Insurance Supervisor (IAIS) solvency requirements.

Finally, the International Accounting Standards Board (IASB) recently released a discussion paper entitled, "Preliminary Views on Insurance Contracts," and has asked for comments by Nov. 16, 2007. It is anticipated the FASB will distribute this report in the United States and ask for comments prior to the cut-off date of the IASB. One thing is for sure about this discussion paper: accountants, lawyers, actuaries and technology/systems professionals will not go without work.

In the next issue of *Taxing Times,* I will summarize the IASB's proposed method of accounting for insurance and attempt to tie it together with GAAP, SSAP & PBR. Unfortunately, I am not sure whether the formula SSAP + PBR will in fact equal IAS. The saga continues.

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Xcel Energy Settles pre-1986 COLI Case with DOJ and IRS

by Chris DesRochers

At a court-supervised mediation, representatives of the Department of Justice, the Internal Revenue Service and Xcel Energy arrived at a proposed settlement of the IRS challenge to the policy loan interest deduction on Xcel's pre-1986 COLI policies. The case was scheduled to go to trial in late July. Under the terms of the settlement, Xcel will pay $64.4 million to settle the government's claim for tax penalties and interest for the years 1993 to 2007. The agreement also provides that Xcel will surrender the policies, but that no tax liability will be assessed under section 72(e). The total exposure for the years at issue in the case was $583 million, which includes tax, interest, and possible penalties.[1]

The Xcel case would have been the first pre-1986 leveraged COLI (contracts purchased before June 20, 1986) to be litigated, as previous cases involved post-1986 contracts (contracts purchased on or after June 20, 1986). Although the government conceded that the policies met the four-out-of-seven rule of section 264, they challenged the COLI policies as a substantive sham, concluding that policy loan interest was not deductible. Pre-1986 contracts were first grandfathered by the 1986 Tax Reform Act, which limited the deductibility of policy loan interest on post-1986 issues to $50,000 per insured employee and later by HIPAA in 1996. While the 1996 legislation phased out the loan interest deduction for post-1986 issues, it allowed future deductions for policy loan interest for pre-1986 contracts but capped the (fixed) deductible policy loan interest at the Moody's Corporate Average Rate for the month in which the policy was issued. By agreeing to surrender the policies, Xcel gave up any potential claims to future policy loan interest deductions after 2007. How and if the terms of the settlement with Xcel will affect other taxpayers with pre-1986 COLI plans under audit remains to be determined.

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[1] XCEL ENERGY INC, 8-K, June 20, 2007.

ACLI's Request for Guidance under New Sections 101(j) and 6039I

by John T. Adney and Bryan W. Keene

On Aug. 17, 2006, Congress passed the Pension Protection Act of 2006 (the "PPA") which, among other things, enacted new federal income tax rules for insurance that an employer purchases (for its own benefit) on the lives of its employees. Under section 101(j), as added by the PPA, death benefits in excess of premiums paid under "employer-owned life insurance contracts" are taxable unless the individuals who are insured fall within certain limited classes (*e.g.,* highly compensated employees) or if the death benefits are used for specified purposes (*e.g.,* for the benefit of the insured's heirs) and unless the employer meets certain notice and consent requirements.[1] The PPA also added section 6039I to the Code, which imposes reporting requirements on holders of employer-owned life insurance contracts. Generally, the insurance industry has been supportive of the new rules, which are widely viewed as codifying "best practices" with respect to corporate-owned life insurance (COLI). The new rules generally apply to contracts issued after Aug. 17, 2006, subject to certain transition rules. (For a more detailed discussion of the new COLI best practices rules, see John T. Adney and Bryan W. Keene, *New "Best Practices" Rules for Corporate-Owned Life Insurance,* in the February 2007 edition of *Taxing Times*.)

On April 11, 2007, the American Council of Life Insurers (ACLI) filed a letter with representatives of the Treasury Department (followed by a meeting with the Treasury Department on May 14, 2007, and subsequent letter dated May 21, 2007) to request guidance on several interpretive matters involving the new COLI best practices rules. The ACLI highlighted a number of issues under section 101(j) that it believes need clarification to assist COLI issuers and owners in implementing the new rules. Several of those issues relate to the notice and consent requirements imposed by section 101(j)(4). Generally, to satisfy those requirements, an employer must (1) obtain each insured's written consent to the coverage and that the coverage may continue after employment, (2) notify each insured in writing of the "maximum face amount for which the employee could be insured at the time of coverage," and (3) inform each insured in writing that the employer will be a beneficiary of the death proceeds. These requirements must be met "before the issuance of the contract."

> In addition to issues relating to the notice and consent requirements, the ACLI requested guidance on several other aspects of the new rules.

In its letter, the ACLI stated that many employers and issuers have experienced administrative difficulties in meeting the notice and consent requirements in connection with contracts issued shortly after the PPA's effective date. As a result, the ACLI asked the Treasury Department to provide an additional transition rule under which the notice and consent requirements would be deemed satisfied for contracts issued within the first few months *after* Aug. 17, 2006, if the requirements otherwise are met within one year of that date. In other words, in these limited cases the notice and consent requirements could be met after a contract was issued. Similarly, the ACLI requested a rule allowing a one-year "correction period" following the issuance of an employer-owned life insurance contract to correct inadvertent failures to comply with the notice and consent requirements, thereby providing a mechanism to address so-called "foot faults" made in implementing the rules. Finally, with respect to the notice and consent requirements, the ACLI requested guidance on the manner in which an employer may satisfy the requirement to notify the insured of the "maximum face amount for which the employee could be insured at the time of coverage," particularly in situations in which coverage is increased. The ACLI suggested that a new notice and consent should not be required merely because of such an increase, as long as the increased coverage does not exceed the amount described in the original notice, whether expressed as a dollar amount or a formula (such as a percentage of salary).

In addition to issues relating to the notice and consent requirements, the ACLI requested guidance on several other aspects of the new rules. Specifically, the ACLI requested guidance on the classes of "highly compensated" persons who can be insured under section 101(j). In that regard, section 101(j)(2)(A)(ii) provides that tax-

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

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free treatment of death benefits under employer-owned life insurance contracts will be retained for any contract that insures the life of a "highly compensated employee" or a "highly compensated individual." The provision cross-references sections 414(q) and 105(h), respectively, for the meaning of these terms, with several differences noted in the statute. The guidance requested by the ACLI seeks clarification on how the rules under sections 414(q) and 105(h) should be interpreted in applying section 101(j).

The ACLI also requested guidance on whether the new COLI best practices rules apply in certain specified instances. In particular, guidance was sought on whether the new rules apply to endorsement split-dollar arrangements, to life insurance owned by a VEBA (i.e., a voluntary employees' beneficiary association), or to life insurance owned by a trust established by business owners under a cross-purchase or stock redemption agreement.

Further, the ACLI requested guidance on several issues relating to the effective date and transition rules under the PPA. As indicated above, section 101(j) generally applies to contracts issued after Aug. 17, 2006 (the "general effective date"), subject to two significant exceptions. Specifically, section 863(d) of the PPA states that 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 [Code] for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract …" The legislative history for the PPA (provided by the Joint Committee on Taxation) also states that certain types of changes (e.g., certain increases in coverage that do not require the insurer's consent) to a contract issued prior to the general effective date will not cause the contract to lose its "grandfathered" status and become subject to the requirements of section 101(j). The ACLI requested guidance on (1) whether these "grandfathering" rules also apply to contracts issued after the general effective date, such that new notice need not be provided and new consents need not be obtained upon the occurrence of such events, and (2) the application of the grandfathering rules in the context of a tax-free exchange under section 1035 and in the context of "deemed exchanges" that result from material changes that are made to an existing contract.

Finally, the ACLI requested guidance on the reporting and recordkeeping requirements imposed by section 6039I. Those requirements state that certain information must be provided on behalf of each "applicable policyholder," which section 101(j)(3)(B) defines to include not only the entity that actually owns the relevant life insurance contract, but also certain related parties. The ACLI expressed a concern that these requirements might be read to impose reporting requirements on multiple entities with respect to the same employer-owned life insurance contract, and that there is uncertainty regarding the specific information that employers will need to assemble to meet the requirements. As a result, the ACLI asked the Treasury Department to provide guidance on these issues. (The IRS has indicated that there will be no reporting form for 2006 but that it is working to provide such a form beginning with the 2007 tax year.)

At the May 31, 2007, Insurance Tax Seminar held by the Federal Bar Association in Washington, D.C., a representative of the Treasury Department indicated that the Department is considering the issues raised by the ACLI. Stay tuned for further developments on these issues in upcoming editions of *Taxing Times*.

Sections 101(j) and 1035—The IRS Issues Rulings Addressing Employer Owned Life Insurance

by John T. Adney and Michelle A. Garcia

In private letter rulings 200711014 (March 16, 2007) and 200715006 (Jan. 9, 2007), the Internal Revenue Service (IRS) addressed the treatment of employer owned life insurance in the context of section 1035 as well as new section 101(j).[1] In both of these rulings, the IRS dealt with the treatment of "partial block" exchanges of life insurance policies covering the lives of the policyholders' employees under the tax-free exchange rules of section 1035, and in the second ruling—the very first ruling issued by the IRS relating to section 101(j), enacted by the Pension Protection Act of 2006—the IRS also addressed the effect of such an exchange for purposes of the effective date of that provision.

Section 1035 and Partial Block Exchanges

In PLR 200711014, a corporate policyholder owned a block of individual, general account life insurance policies that, at the time the policies were first issued, covered the lives of active employees of the company. The policies involved in the ruling were modified endowment contracts under section 7702A (MECs).

[1] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended.

The policyholder told the IRS that it wished to exchange a portion of the block of policies, *i.e.,* those covering the lives of its active employees, for new separate account policies issued by a different carrier, and to retain the existing policies covering its inactive (*i.e.,* retired or terminated) employees. The ruling held that an exchange of only part of a block of policies for new policies issued by a different carrier qualifies as a section 1035 exchange—technically, as a series of section 1035 exchanges. In so ruling, the IRS dismissed speculation by some that section 1035 would only apply to the exchange of all policies held by a corporate policyholder—both those covering active employees and those covering inactive employees—*en masse* for policies from the new carrier. The speculation seemingly was based on a theory that if a block of policies issued at the same time by the same carrier consists of MECs, allowing only a portion of the block to be exchanged tax-free would enable the exchanged portion to escape the aggregation with the portion left behind that is mandated by section 72(e)(11). The speculation was groundless, of course, and even its supposed theory was rejected in a more recently published Revenue Ruling that expressly held against applying the aggregation rule across such an exchange (*see* Rev. Rul. 2007-38, published in the Internal Revenue Bulletin on June 18, 2007).

The exchange of only a portion of the block of policies, *i.e.*, those covering active employees, allows a company to avoid the disallowance of interest deductions potentially posed by section 264(f)(1). As addressed in PLR 200627021 (July 7, 2006), an exchange of life insurance policies retriggers testing under section 264(f), with the result that policies received in an exchange covering insureds who are not active employees at the time of the exchange would not qualify for the exception to the disallowance under section 264(f)(4)(A) (exchanged policies covering active employees at that time would qualify for the exception). In PLR 200711014, the policyholder was a life insurance company, and the IRS noted that section 264(f) technically does not apply to the policyholder due to the rule in section 264(f)(8)(B).

The second of the two recent private letter rulings, PLR 200715006, also confirms that a corporate policyholder can effect a section 1035 exchange of only part of a block of policies, *i.e.,* the policies covering the active employees. Under the facts of this ruling, the policyholder owned single premium individual life insurance policies and certificates under group life insurance policies that covered the lives of its active employees at the time the policies and certificates were issued. All of the policies were MECs based on the general accounts of the issuing insurers, and with respect to the group life insurance, the taxpayer represented that it treated each individual certificate issued under each group master contract as a separate contract for purposes of sections 817(h), 7702, and 7702A. As in the first ruling discussed above, the policyholder proposed to exchange the policies and certificates covering its active employees for new individual life insurance policies from a different carrier, and to retain the existing life insurance covering its inactive employees. In ruling that the exchange of a portion of the block of policies qualifies as a section 1035 exchange, the IRS applied the same analysis as in PLR 200711014, and it extended that analysis to the exchange of a portion of group life insurance certificates.

Section 1035 Exchanges and New Section 101(j)

PLR 200715006 also addressed, for the first time, the application of new section 101(j) in a section 1035 exchange transaction. In the case of employer owned life insurance, *i.e.,* coverage of employees for the benefit of employers, section 101(j) limited the tax-free treatment of death benefits historically available under section 101(a)(1) to policies covering insureds whom the statute defined as highly compensated or to policies the death benefits of which were used for specified purposes (*e.g.,* to provide a death benefit to the insured's heirs), and then only if the prospective insureds were given certain notices and consented in writing to the coverage before it took effect.

All of the existing policies involved in PLR 200715006 were general account policies issued prior to the effective date of section 101(j), which generally applies to policies issued or treated as issued after Aug.17, 2006. Under the facts of the ruling, the policies to be received in the exchange (which would occur after that effective date) would be based on a separate account of the new carrier. However, beyond the change in carriers and the change from the general account to the separate account, the new policies would be the same as the old policies and retain the same face amounts (except as necessary to comply with the cash value accumulation test or the guideline premium and cash value corridor requirements under section 7702). Further, the taxpayer represented that

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the proposed exchange would not involve any material increase in the death benefits and would not effect any other material change in policy terms.

After ruling that the exchange qualified as a tax-free exchange under section 1035, the IRS also held that the policies received in the exchange would not be treated as issued after the effective date of section 101(j) and a companion provision, section 6039I (imposing certain reporting requirements relating to policies subject to section 101(j)), for the reason that section 1035 applied to the exchange. While sections 101(j) and 6039I generally are effective for policies issued after Aug. 17, 2006, a transition rule in the Pension Protection Act excludes from this policies issued after that date in a section 1035 exchange for pre-Aug.17, 2006 policies. The same transition rule, however, further states that this grandfathering is lost if there is "any material increase in the death benefit or other material change" to a contract. The juxtaposition of these concepts within the same rule poses a conundrum of sorts, since the tax law generally considers an exchange to be a material change and *vice versa.* The legislative history of the Pension Protection Act provides no enlightenment on this, although it does state that a change from a general account contract to a separate account contract and a death benefit increase required by section 7702 would not give rise to a material change for this purpose.

While PLR 200715006 confirms that a section 1035 exchange—at least under the facts of that ruling—will not cause a loss of grandfathering under sections 101(j) and 6039I, the utility of this conclusion to other taxpayers is hampered by the fact that the IRS did not address in any way what constitutes a material change in the terms of a contract and how, if at all, that relates to the section 1035 reference in the transition rule. The taxpayer represented that no material change would occur, thus rendering it unnecessary for the IRS to address this legal issue. In view of the legislative history of section 101(j) noted above, it probably is fair to conclude that the IRS would not view a change in the identity of the carrier alone, or a change from a general account contract to a separate account contract, as a material change that would trigger a loss of grandfathering. Further, notwithstanding the fact that the taxpayer represented away the material change issue, it is unlikely that the IRS would have accepted the representation and issued the ruling unless it was comfortable, at least at some level, that the changes involved in the exchange were properly not treated as material changes. That said, however, one should not draw much comfort from the ruling beyond its specific facts, which were cryptic in the IRS's retelling. Technically, only the taxpayer to whom the ruling was issued may rely on it (*see* section 6110(k)(3)), and thus far, only that taxpayer has the comfort of knowing that the facts it showed to the IRS led to a favorable holding under the Pension Protection Act's somewhat confusing transition rule. The downside of being wrong on this issue, of course, is draconian for the policyholder—the loss of tax-free death benefits—and thus the course followed by the taxpayer in seeking the ruling that resulted in PLR 200715006 was well advised.

IRS Rules that Retroactive Reinsurance Is Not Reinsurance for Tax Purposes

by Susan J. Hotine, Peter H. Winslow and Lori J. Jones

In PLR 200711017 (Dec. 14, 2006), the IRS National Office ruled that loss portfolio reinsurance (which is generally accounted for as retroactive reinsurance under SSAP 62) between two related insurance companies does not qualify as insurance for tax purposes, even though the reinsurance satisfied the criteria for risk transfer under SSAP 62 for property and casualty reinsurance and even though the state insurance department confirmed that reinsurance accounting treatment is correct. Because the agreement between the companies covered only loss reserves related to insured events that already had occurred, the ruling notes that "the element of fortuity is absent" and concludes that the agreement transfers only a timing and investment risk. Noting that the taxpayer could not procure an arrangement with similar terms in the commercial reinsurance market because, in part, if the companies were unrelated, the same statutory accounting treatment would not be available, the ruling also concludes that the reinsurance agreement is not insurance in the commonly accepted sense "as envisioned by the caselaw."

The ruling considers an agreement between a reinsurance company and its parent (another reinsurance company) under which the subsidiary company transferred or ceded its liability for losses (including loss adjustment expenses and incurred-but-not-reported losses) to its parent company, for losses occurring no later than a specific year that was several years before the agreement.

The ceding company paid an amount equal to the statutory reserves being transferred, and such amount was placed in a notional account to which a set rate of interest would be credited. The assuming company is obligated to pay any losses covered by the agreement up to an aggregate limit. If at any time the amount of claims exceeds the balance in the notional account, the assuming company must pay the excess up to the aggregate limit; if the balance in the notional account exceeds the claims paid at the end of the contract, the positive balance will be remitted to the assuming company. The facts note that, but for the companies being related, SSAP 62 would require the agreement to be accounted for as retroactive reinsurance. Because the companies are related and because the agreement meets SSAP's criteria for risk transfer, the companies are allowed to account for the agreement as prospective reinsurance.

The IRS granted the ruling that was requested by the taxpayer—that the retroactive reinsurance agreement does not constitute insurance.

The ruling cites Rev. Rul. 89-96, 1989-2 C.B. 114, and the analysis therein for retroactive insurance, apparently applying it to determine whether the reinsurance transaction should be treated in a similar manner for tax purposes. Rev. Rul. 89-96 involves a situation where a direct writer of insurance attempted to "insure" losses from events that already had occurred (otherwise known as retroactive insurance), using an "insurance contract" that placed a cap on the insurer's liability. In addition, it was anticipated that the actual losses would substantially exceed the cap. The ruling concludes that, because the losses already had been incurred by the insured and the insurer's liability exposure was capped, only investment and timing risks were involved, not insurance risks.

In PLR 200711017 the IRS appears to have concluded that the reinsurance contract itself must involve the element of fortuity in order for the transaction to be treated as insurance for tax purposes. This seems to depart from what has been the IRS' administrative position—that, in determining whether reinsurance is valid insurance and whether the liabilities transferred are valid insurance liabilities or reserves, one would look to whether the directly-written contracts are/were valid insurance, recognizing that reinsurance is the method for transferring insurance liabilities between insurance or reinsurance companies. The ruling does not address the fact that the reinsured loss reserves represent valid insurance risks on the books of the ceding company and does not answer why, given this fact, the loss reserves would not also be valid insurance risks for the assuming company.

Moreover, the ruling's reliance on the fact that an arrangement with similar terms is not available in the commercial reinsurance market as support for a conclusion that the agreement is not insurance is questionable. This conclusion appears to be inconsistent with the reasoning in the captive insurance cases, where the fact that commercial insurance is not available is a factor that supports insurance treatment if risk transfer otherwise is present. The ruling seems to be influenced by the fact that under SSAP 62 special accounting treatment is required for retroactive reinsurance. While this is true, that accounting treatment does not negate risk transfer or qualification of the arrangement as reinsurance for regulatory purposes.

The ruling also seems to be in conflict with the I.R.C. § 338 regulations. Where a company is acquired in a stock purchase, I.R.C. § 338 permits the parties to elect to treat the acquisition for tax purposes as if all of the assets were purchased. Treas. Reg. § 1.338-11T requires that, in the case of insurance companies, the deemed asset purchase must be effectuated as if a reinsurance transaction had occurred. The regulations make clear that the reinsurance treatment applies to the transfer of all of the seller's unpaid loss reserves, giving explicit recognition to retroactive reinsurance for tax purposes. It is difficult to reconcile the conclusion of PLR 200711017 with the I.R.C. § 338 regulations except to assume that there must be something unique in the taxpayer's facts unstated in the ruling that dictated a different result.

The IRS granted the ruling that was requested by the taxpayer—that the retroactive reinsurance agreement does not constitute insurance. One might speculate that the ruling was requested so that the payment made by the parent corporation to the subsidiary could be treated as a contribution to capital, or perhaps because the assuming company is foreign and the non-insurance ruling eliminates the application of any excise tax. Informally, IRS personnel have emphasized that the ruling only applies to this particular taxpayer. For this reason, it is questionable whether the IRS will rely on this

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ruling to attack reinsurance accounting in audits of other taxpayers.

Although reason might dictate that the IRS should not conclude that retroactive reinsurance, *per se,* fails to qualify as insurance, it might not prevent the IRS from questioning these arrangements using the retroactive insurance analysis. In a field attorney advice memorandum (FAA 20072502F (May 8, 2007)), the IRS' Associate Industry Counsel Property and Casualty Insurance (Large and Mid-Size Business) also concluded that no insurance risk was transferred in a retroactive reinsurance transaction between unrelated insurance companies. The facts in the memorandum are sketchy, but it appears that the

assuming company reinsured 30 percent of the risks of incurred losses from an unrelated insurer on a funds withheld basis. The assuming company analyzed the transaction under five cash flow scenarios and concluded that it satisfied the criteria for risk transfer under SSAP 62. FAA 20072502F starts from the premise that the analysis applied to retroactive insurance under Rev. Rul. 89-96 must be applied to a reinsurance transaction to determine whether insurance risk is transferred.

Referring to Rev. Rul. 89-96, FAA 20072502F appears to fashion a test to determine whether there has been adequate risk transfer in a reinsurance transaction, explaining it as follows:

> The Service contends that in essence, Revenue Ruling 89-96 equates the tax savings received, when booked as an underwriting loss, to an additional premium which the taxpayer can invest to cover expected claims. Therefore, to evaluate the economics of the transaction, this tax savings along with the actual premium is compared to the net present value (NPV) of the anticipated losses. If the NPV of the anticipated losses do not materially exceed the premium plus the tax savings, the transaction does not transfer insurance risk for federal income tax purposes.

FAA 20072502F applies this test to the assuming company's five scenarios and concludes that, because of the "tax benefits" to the assuming company (which seems to have been identified as the up-front net deduction for reserves), there was no realistic possibility of an economic loss. The memorandum appears to ignore the fact that the "tax benefits" for the assuming company are the same as those already enjoyed by the direct-writer—the recognition of loss reserves. The reinsurance transaction does not create a new tax benefit, but merely transfers the tax benefit of loss reserves from one insurance company to another. This is a contrast to the situation in Rev. Rul. 89-96 where the "insurance" transaction was designed to obtain tax benefits for the taxpayer being "insured" (*i.e.*, an up-front premium deduction). Moreover, The FAA does not consider the full consequences of concluding that the reinsurance transaction does not transfer risk; if it is not reinsurance for the assuming company, then it is not reinsurance for the ceding company and the tax benefits of the loss reserves remain with the ceding company. Also, by focusing on only the assuming party and its potential tax benefit (the up-front net deduction for reserves), the post-tax economic analysis of the FAA's test is circular. The tax benefits derived by the assuming company's up-front reserve deduction causes the FAA to conclude that there is no transfer of risk and therefore the assuming company should be denied the tax benefit. However, once the assuming company has been denied an up-front deduction for the transferred reserves, and that tax benefit is not taken into account, under the FAA's analysis, one would have to conclude that there is transfer of risk, making the transaction insurance, and making the assuming company entitled to an up-front reserve deduction. Moreover, the recent COLI cases suggest that the economic substance of a purported insurance transaction should be analyzed on a before-tax basis. *See American Electric Power Company, Inc. v. United States,* 326 F.3d 737, 743-744 (6th Cir. 2003). Again, it is questionable whether reliance on the retroactive insurance analysis of Rev. Rul. 89-96 is appropriate to

determine whether there is risk transfer in a reinsurance transaction.

Up until PLR 200711017 and FAA 20072502F, the analysis associated with retroactive insurance (*i.e.*, whether or not the event insured against had occurred) has not been applied to reinsurance transactions. With reinsurance, there are directly-written contracts and insurance coverage is involved; the only question is whether the risk associated with that coverage has been transferred. The fact that the losses already have been incurred by the insurer under the directly-written contracts should be irrelevant as long as it is reasonably possible that the assuming company will incur a significant loss in assuming all or part of the risk covered by those contracts.

The IRS itself apparently is rethinking whether the principles of Rev. Rul. 89-96 should apply to retroactive reinsurance. Shortly after PLR 200711017 and FAA 20072502F were released, the IRS issued Rev. Rul. 2007-47, 2007-30 I.R.B. 127, which holds that a taxpayer's purchase of "insurance" to cover the future costs of restoring its business location to its condition prior to when the taxpayer's business operations were begun does not qualify as insurance for tax purposes. The business is harmful to people and property, and governmental regulations require the taxpayer to remediate that harm. The ruling reasons that the arrangement lacks the requisite element of "fortuity" because, although the exact amount and timing of the costs to be incurred are not known, it is certain that they will be incurred.[1] At the end of the ruling, the IRS specifically states that the ruling's conclusion does not apply to reinsurance arrangements, including retroactive reinsurance, such as loss portfolio transfers. Nevertheless, the IRS leaves open its option to apply the principles of Rev. Rul. 89-96, and other authorities dealing with directly-written "insurance," to reinsurance on a case-by-case basis, and asks for comments on this topic to be submitted by Oct. 22, 2007. We expect that comments will be filed asking the IRS to clarify that the broad language of PLR 200711017 and the test set forth in FAA 20072502F should not be followed by the IRS.

IRS Issues Exam Guidelines to Promote Consistency

by Samuel A. Mitchell

In recent months various IRS and Chief Counsel officials have made public statements regarding the need for consistency in examinations of large corporate taxpayers. For example, readers who attended the Federal Bar Insurance Tax Conference heard Chief Counsel Korb highlight successful efforts in recent months to issue more guidance for field agents and taxpayers. Nevertheless, the IRS seems to have had some difficulty asserting control over high-profile issues. This may be the result of a reorganization that occurred late last year to realign IRS resources more along geographic lines. In order to remedy the perceived problem with inconsistency, the Large and Mid-Size Business Division (LMSB) recently published new "rules of engagement" for the examination of large and mid-size taxpayers. LMSB refers to the new rules as its Industry Issue Focus approach.

Under the new rules of engagement, contained in section 4.51.1 of the Internal Revenue Manual, LMSB has divided examination issues into a three-tiered system. Tier I issues are those that the IRS thinks present the most risk for non-compliance. The Tier I list currently includes all listed transactions (transactions the IRS has designated as potentially abusive tax shelters) and 14 other issues. Under the new rules, LMSB has appointed a single IRS employee as the Issue Owner Executive for each Tier I issue. The new rules establish a protocol under which examiners must coordinate the resolution of each Tier I issue through the Issue Owner Executive. Under the protocol for Tier I issues, examiners will have no discretion in applying guidance to a taxpayer's facts and circumstances and the Issue Owner Executive has nationwide jurisdiction including issue resolution.

Tier II issues currently include 11 important general issues that present what the IRS considers to be an elevated compliance risk. LMSB has appointed an Issue Owner Executive through which each Tier II issue must be coordinated; however, examiners will have some discretion in resolving Tier II issues. Tier III issues present less compliance risk and hence call

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[1] Rev. Rul. 2007-47 follows a number of IRS Chief Counsel memoranda that hold that contracts that would indemnify a nuclear power plant for future decommissioning costs do not qualify as insurance. CCAs 200629028 and 200629029 (Apr. 14, 2006); CCA 200703007 (Jan. 19, 2007).

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In keeping with the IRS's recent efforts to centralize control, insurance companies can expect only increased scrutiny and a centralized, coordinated approach from the IRS, and the industry should not be surprised if issues appear on the Industry Issue Focus Approach lists.

for less coordination, but are still important. Currently, the IRS has not put any issues on the Tier III list. The Tier I, II and III issues will appear on the IRS's Web site (www.irs.gov) as they are designated. There are links to Directives on most of the identified issues, and some of the Directives identify subissues for consideration. A special committee within LMSB will designate Tier I and II issues, and the Field will designate Tier III issues.

There are no insurance-specific issues on the Tier I or Tier II lists.[1] There is, however, at least one general tax issue on the Tier I list that is prevalent in the industry. The issue involves the application of I.R.C. § 162(f) to settlement payments to the government. I.R.C. § 162(f) disallows the deduction of a fine or penalty paid to the government as the result of a violation of the law. As a follow-up to the Industry Issue Focus approach, the IRS recently released a Directive on the I.R.C. § 162(f) issue. (Industry Director Directive on Government Settlements Directive #1, LMSB-04-0507-042.) Many health insurance companies have had the issue in recent years. In fact, the IRS states in the Directive that over 75 percent of settled cases involve health care fraud, primarily regarding Medicare payments. These cases involve False Claim Act (FCA) cases brought by the government. The controversy involves the allocation of settlement payments between those imposed to encourage prompt compliance with the law or as a remedial measure to compensate another party, which are deductible, and those imposed in order to enforce the law and punish the violator, which are not deductible. The Directive provides guidance regarding how to draw the line between the deductible and non-deductible portions on a facts-and-circumstances basis and requires the examiner to coordinate with the Department of Justice attorney who handled the settlement in all FCA settlements that exceed $10 million. There may be more activity on this issue in the near future, as Wellpoint, Inc. currently is litigating the issue in the Tax Court. (Wellpoint, Inc. v. Commissioner, Doc. No. 13585-05, USTC, filed July 21, 2005).

A second issue, on the Tier II list, may touch the insurance industry's treatment of bad debt deductions in the mortgage business. The issue is labeled as the "non-performing loans" issue. It probably is intended to address how banks account for the timing of bad debt deductions on non-performing loans, but there is no way to tell at this point whether the insurance industry will be swept into the issue coordination because the IRS has not yet published a Directive or specifically referred to existing guidance on the issue.

Although no core insurance tax issues have yet been designated, this does not mean that insurance companies will be subject to a lesser level of audit scrutiny. Insurance tax issues already are subject to an increasingly coordinated approach with heavy involvement by IRS actuaries and at least two Chief Counsel attorneys who specialize respectively in life and property/casualty insurance issues. In keeping with the IRS's recent efforts to centralize control, insurance companies can expect only increased scrutiny and a centralized, coordinated approach from the IRS, and the industry should not be surprised if issues appear on the Industry Issue Focus Approach lists.

No Section 1035 Exchange Where Taxpayer Endorses Received Check to Second Life Insurance Company

by Mark E. Griffin and Michelle A. Garcia

On May 2, 2007, the Internal Revenue Service (IRS) released Rev. Rul. 2007-24, 2007-21 I.R.B. 1282, in which it held that the receipt of a check from a life insurance company under a nonqualified annuity contract, followed by the endorsement of the check to a second company as consideration for a second annuity contract, does not qualify as a tax-free exchange under section 1035 of the Internal Revenue Code. The IRS has taken this position in a number of private letter rulings that have limited application to the taxpayers who requested the rulings,[1] and the IRS apparently felt the need to publish guidance of more general applica-

[1] At the time of publication, there may be more issues on the Tier I, II and III lists than referenced above.

bility on this issue. The IRS, in Rev. Rul. 2007-24, appears to reject the position taken by the Tax Court in *Greene v. Commissioner,* 85 T.C. 1024 (1985), that tax-free treatment under section 1035 applies under similar facts. It is interesting to consider whether the IRS might have reached a different conclusion in Rev. Rul. 2007-24 if the transaction at issue involved slightly different facts, as discussed below.

Section 1035(a) provides generally that no gain or loss is recognized on certain exchanges of insurance products, including the exchange of an annuity contract for another annuity contract. For purposes of section 1035, it is clear that an exchange of a contract can be accomplished by assigning the contract directly to a new insurer as consideration for a new contract.[2] The IRS has traditionally taken the position that where a taxpayer receives funds from the surrender of one annuity contract and immediately applies such funds to the purchase of a second annuity contract, such transaction does not qualify as a tax-free exchange under section 1035.[3] The IRS likewise has taken this position where a taxpayer receives a check from a life insurance company for the surrender of an annuity contract and endorses the check to another life insurance company as consideration for the issuance of another annuity contract.[4]

Rev. Rul. 2007-24 involves an individual who owned a nonqualified annuity contract issued by a life insurance company (IC1). The individual, intending for the transaction to be treated as a tax-free exchange under section 1035, requested that the first life insurance company, IC1, issue directly to another life insurance company (IC2) a check as consideration for a new annuity contract to be issued by IC2. IC1 refused the individual's request and, instead, issued the check to the individual. Upon receiving the check, the individual endorsed the check directly to IC2 as consideration for a new annuity contract. The IRS concluded generally that the transaction did not qualify for tax-free treatment under section 1035, and that the amount of the check was "an amount not received as an annuity" that was taxable to the extent of any gain on the original contract under the so-called "income-first" rule under section 72(e).

In reaching this conclusion, the IRS reasoned that there was no actual exchange of annuity contracts, the individual did not assign the IC1 contract to IC2, and there was no direct transfer from IC1 to IC2 of the cash value of the old contract in exchange for the new contract. The IRS stated in the revenue ruling that "[n]either § 1035 nor the regulations make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract." In addition, because the annuity contract was a nonqualified contract, none of the tax-free rollover provisions set forth in the Internal Revenue Code, such as the provision provided in section 403(a)(4), apply to the amounts received from the IC1 contract.

The question remains whether a court might hold that the transaction in Rev. Rul. 2007-24 constituted a tax-free exchange under section 1035, based on the rationale of the Tax Court in the *Greene* case. The *Greene* case involved a taxpayer who held a section 403(b) annuity contract issued by a life insurance company, which she surrendered for the payment of proceeds in 1980,

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[1] See Internal Revenue Code section 6110(k)(3).

[2] John T. Adney, Joseph F. McKeever III, & Barbara N. Seymon-Hirsch, *Annuities Answer Book* 7-51, Q 7:70 (4th ed. 2005) ("An exchange of contracts typically involves the assignment of a contract to an insurer for the issuance of a new contract"); *see also* Rev. Rul. 72-358, 1972-2 C.B. 473 (assignment of a life insurance contract issued by one insurance company to a second insurance company in exchange for a variable annuity contract issued by the second company is treated as a tax-free exchange under section 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (concluding that an assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned annuity contract into a pre-existing annuity contract owned by the same taxpayer, and issued by the second insurance company, is a tax-free exchange under section 1035).

[3] *See, e.g.,* PLR 200622020 (Feb. 8, 2006) (concluding that, for purposes of sections 72 and 1035, where the full amount of an annuity contract had been distributed to the grantor trust, the taxpayer was not entitled to roll over the amount received into another annuity contract or to use the proceeds received to purchase a second annuity contract in a transaction that qualifies for tax-free exchange treatment under section 1035); and PLR 8310033 (Dec. 3, 1982) (concluding that the proposed surrender of a group annuity certificate and subsequent purchase of a new annuity contract with the surrender proceeds is not a tax-free exchange under section 1035).

[4] *See, e.g.,* PLR 8515063 (Jan. 15, 1985) (concluding that the proposed surrender of an annuity contract and subsequent purchase of another annuity contract with the surrender proceeds, even where the taxpayer proposed to directly endorse the check received from the surrender of the first annuity contract to the issuer of the second annuity contract, is not a tax-free exchange under section 1035).

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intending to use the proceeds to purchase a new section 403(b) annuity contract from another life insurance company. Shortly after receiving the check from the first life insurance company she endorsed the check to the second life insurance company in exchange for a new 403(b) annuity contract. In *Greene,* the Tax Court held, over the IRS's objection, that such transaction qualified as a valid section 1035 exchange. The court, in reaching its conclusion, stated that it was satisfied that "Congress intended the use of the word [exchange] in [a] broader sense, as where the taxpayer gives up an insurance contract with one company, in order to procure the same or a comparable contract from another company." The court also noted that Treas. Reg. section 1.1035-1 "requires only that the insurance contracts be of the same type, *e.g.*, an annuity for an annuity, and that the obligee under the two contracts be the same person."

Query whether a court presented with the facts in Rev. Rul. 2007-24 would adopt the Tax Court's reasoning in the *Greene* case and, contrary to the IRS's position in that ruling, hold that the transaction involved constitutes a tax-free exchange under section 1035. It appears that the Tax Court's reasoning in *Greene* is equally applicable today. On the other hand, perhaps changes in the tax law since the *Greene* case might affect whether a court today would apply section 1035 in the same manner as the Tax Court in the *Greene* case.

In particular, as mentioned above, the *Greene* case involved a transaction intended to qualify as a tax-free transfer between section 403(b) arrangements. The transaction occurred prior to the IRS's issuance of Rev. Rul. 90-24, 1990-1 C.B. 97, which allows tax-free trustee-to-trustee transfers between section 403(b) arrangements. In addition, the transaction in Greene occurred prior to the enactment of the eligible rollover rules under sections 401(a)(31) and 403(b)(8) that allow tax-free rollovers of certain distributions from "eligible retirement plans," including rollovers between section 403(b) arrangements. The court may have been sympathetic to the taxpayer in *Greene* because section 1035 appeared to provide the only basis to accomplish the desired tax-free transfer in that case. Today, the type of transaction in the *Greene* case would be covered by the eligible rollover rules and, as such, presumably a court today would not apply section 1035 to such transactions. However, it is not clear why the existence of other permissible methods of accomplishing a tax-free transfer should affect whether a transaction like the one in *Greene,* and the similar transaction in Rev. Rul. 2007-24, qualifies for tax-free exchange treatment under section 1035.

It is interesting to note that the IRS indicated generally in *Greene* that it would have treated the transaction in that case as a tax-free exchange under section 1035 if the check to the taxpayer was endorsed over to the new insurer pursuant to a binding agreement with the new insurer to purchase a new annuity contract. The IRS in Rev. Rul. 2007-24 does not address what effect, if any, such a binding agreement might have on the IRS's position in that ruling. It is unclear whether the IRS continues to be of the view it took in *Greene* that the endorsement of a check from an insurance company under a contract pursuant to a binding agreement with a new insurance company qualifies for tax-free treatment under section 1035. If so, the IRS would have reached a different conclusion in Rev. Rul. 2007-24 if the taxpayer and the new insurer entered into such a binding agreement.

FIN 48 Developments
by Samuel A. Mitchell

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The IRS has released two internal documents regarding FIN 48. The first, a May 10, 2007 Memorandum from LMSB Commissioner Deborah Nolan, provides general information to LMSB executives, managers and examiners regarding the IRS's current policies and possible future developments regarding FIN 48.[1] The Memorandum confirms IRS Chief Counsel's opinion that FIN 48 Workpapers are Tax Accrual Workpapers subject to the IRS's current policy of restraint.[2] Under the current policy of restraint, the IRS will not request Tax Accrual Workpapers from a taxpayer unless certain defined circumstances exist (*e.g.*, if the taxpayer does not disclose a transaction the IRS has listed as a potentially abusive tax shelter).[3] It also announces the creation of an LMSB Tax Accrual Workpapers Cadre whose members will assist examiners in requests for Tax Accrual Workpapers under the policy of restraint, a new requirement for six hours of Continuing Professional Education regarding FIN 48, the release of an Audit Field Guide, and provides another reminder

[1] *Memorandum For Executives, Managers, and Examiners–Large and Mid-Sized Business Division* (May 10, 2007, LMSB-04-0507-044).

[2] *Memorandum from Donald Korb, IRS Chief Counsel, Subject: FIN 48 & Tax Accrual Workpapers,* AM 2007-0012 (March 22, 2007).

[3] *Internal Revenue Manual,* IRM 4.10.20.

that the IRS is reviewing and reconsidering its current Tax Accrual Workpaper policy of restraint.

The second document is the Audit Field Guide referenced in Ms. Nolan's Memorandum.[4] The Field Guide describes the general FIN 48 process for identifying and accounting for uncertain tax positions and poses 10 questions and answers about how examiners should deal with the new accounting standard and the disclosures there under. The Questions and Answers provide interesting insights into what the IRS is thinking about the FIN 48 process. For example, in answer to the first question, "Are FIN 48 Disclosures a Roadmap for the IRS?," the Field Guide acknowledges that FIN 48 footnote disclosures in financial statements may not specifically identify issues, but it nevertheless encourages examiners to seriously consider the disclosures in their examination planning process. It encourages examiners to not be reluctant to pursue matters mentioned in FIN 48 disclosures, while still being mindful of the current Tax Accrual Workpaper Policy of restraint. What this may mean, practically speaking, is that IRS examiners may issue broad Information Document Requests (IDRs) that are driven by FIN 48 disclosures but do not expressly ask for audit workpapers relating to the issue. As an example, the Field Guide suggests that if a taxpayer discloses a FIN 48 liability concerning Subpart F income but does not reflect any Subpart F income on its return, IDR questions should be issued requesting an explanation.

> The Field Guide describes the general FIN 48 process for identifying and accounting for uncertain tax positions and poses 10 questions and answers about how examiners should deal with the new accounting standard and the disclosures there under.

The other nine Questions and Answers in the Field Guide deal with extensions of tax years through restricted consents, the use of closing agreements and the effectively settled standard under FSP FIN-48-1, among other things. Its analysis of the effectively settled standard is one of the more interesting points in the Field Guide. In a nutshell, the effectively settled standard allows a company to release a FIN-48 liability regarding an uncertain tax position if the taxing authority has examined the tax year and closed its examination. If the statute of limitations is still open, the company may release the liability if the tax year is "effectively settled," meaning that it is "highly unlikely" that the taxing authority will reopen the examination. The Field Guide reminds examiners of the IRS's general policy that it will not reopen an exam year after it has been closed unless exceptional circumstances exist. The policy regarding reopening of closed years is stated in the Internal Revenue Manual at IRM 1.2.1.4.1 P-4-3 (12-21-1984) and in Rev. Proc. 2005-32, 2005-23 I.R.B. 1206. Interestingly, the Field Guide highlights the exceptional circumstances standard and acknowledges that "it is possible that reopenings will occur more frequently because of the potentially increased availability of information warranting reopening." The exceptional circumstances are 1) fraud, misrepresentation or concealment of a material fact; 2) a substantial error based on an IRS position that was established at the time of the exam; or 3) a serious administrative omission. See IRM 1.2.1.4.1 P-4-3 (paragraph 1). Examiners rarely attempt to reopen under these exceptional circumstances, perhaps because I.R.C. § 7605(b) discourages it and the above IRM provision and Rev. Proc. 2005-32 require prior approval by an IRS executive. As things stand now, it usually can be said that it is unlikely that an exam will be reopened, but how the IRS will react to large FIN 48 releases on effective settlement remains to be seen.

New Ruling on Section 264(f) and Insurance Company Owned Life Insurance

by John T. Adney and Michelle A. Garcia

The Internal Revenue Service (IRS) recently issued an adverse private letter ruling (dated May 3, 2007) addressing the income tax treatment under Subchapter L of life insurance held by an insurance company, as owner and sole beneficiary, covering the lives of its officers, employees, and directors (insurance company owned life insurance or I-COLI). The ruling was released to the American Council of Life Insurers (ACLI) by the taxpayer and is scheduled to be released to the public by the IRS in early August.

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[4] *FIN 48 publications LMSB Field Examiner Guide* (May 2007, LMSB 04-0507-045).

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Background

When Congress enacted section 264(f) in 1997, it chose not to apply that provision to insurance companies. Rather than disallowing interest expense deductions under section 264(f) with respect to "unborrowed cash values" of life insurance coverage obtained by the taxpayer on insureds other than officers, employees and directors, Congress imposed rules causing the loss of reserve deductions in such a case where the taxpayer was an insurance company subject to taxation under Subchapter L (sections 801-848 of the Internal Revenue Code). (Congress knew that disallowing interest expense deductions would have only limited effect on insurance companies.) Specifically, if a life insurance company holds life insurance policies with unborrowed cash values otherwise described in section 264(f), the amount of the reserve increase or decrease taken into account in computing the company's taxable income is adjusted to reflect such unborrowed cash values. *See* sections 264(f)(8)(B), 807(a)(2)(B), and 807(b)(1)(B). In the case of a non-life insurance company holding such policies, the amount of the company's losses incurred deduction is reduced. *See* 832(b)(5)(B)(iii). These rules essentially treat the cash values of such policies in the same manner as other tax-favored income items under the so-called proration rules.

While insurance companies are thus subject to their own deduction disallowance regime rather than the interest deduction disallowance regime in section 264(f), the two regimes are linked together and were enacted in tandem by the same section of the Tax Relief Act of 1997. In addition, the deduction disallowance rules for insurance companies state that they apply only to "life insurance policies and annuity and endowment contracts to which section 264(f) applies." *See* sections 805(a)(4)(C)(ii), 805(a)(4)(D)(iii), and 832(b)(5)(B)(iii).

To date, insurance companies and their tax advisors generally have read the phrase "contracts to which section 264(f) applies" to mean that life insurance contracts excepted from the interest deduction disallowance rule of section 264(f) (*e.g.,* contracts that cover officers, employees and directors and thus fall within the section 264(f)(4)(A)(ii) exception) are not "contracts to which section 264(f) applies." This interpretation permits insurance companies, like banks and other corporations, to purchase life insurance on their officers, employees and directors without losing income tax deductions.

The Ruling

In this new ruling, the IRS addressed the meaning of the phrase "contracts to which section 264(f) applies" but concluded, instead, that life insurance policies purchased by an insurance company on its officers, employees and directors are described in that phrase. Accordingly, under the ruling, an insurance company holding such contracts will have reserve or losses incurred deductions disallowed even where the contracts are described in the section 264(f)(4)(A)(ii) exception. In reaching its conclusion, the IRS reasoned that the language of the exception in section 264(f)(A)(ii) is that section 264(f)(1) will not apply to contracts that qualify for the exception, *i.e.*, contracts covering officers and employees are excluded *only* from section 264(f)(1), *not section* 264(f) in its entirety. Consequently, the IRS determined that the exceptions in section 264(f)(4) do not apply in the case of I-COLI and, as such, unlike banks and other corporations, insurance companies are not entitled to the benefit of the section 264(f) exceptions.

This conclusion is based solely on the IRS's reading of the applicable statutory provisions—which differs from the industry's reading of those provisions—and does not address any possible policy reasons for denying insurance companies the benefit of the section 264(f) exceptions that are provided to banks and other corporate policyholders. Because of the ruling's potentially great significance and its highly doubtful rationale, efforts are underway to have the ruling reexamined within the IRS. Hopefully, the ruling will be revoked in the not too distant future, to be replaced with guidance reaching a contrary, and supportable, holding.

Editor's Note: As of Aug. 23, 2007, the IRS had not taken any further action with respect to this ruling.

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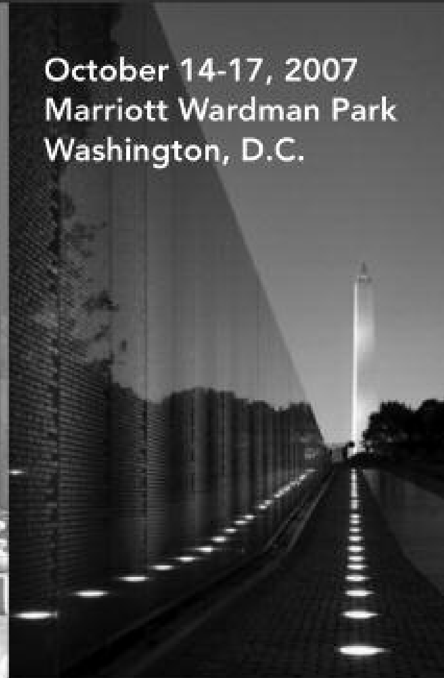

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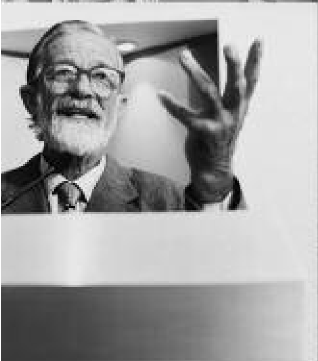

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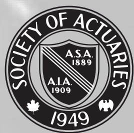

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