



HOW TAX REFORM COULD ADVERSELY AFFECT LIFE INSURANCE COMPANY REGULATORY CAPITAL

By Arthur C. Schneider and Pete Bautz

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Regulatory capital is the lifeblood of the life insurance industry. Adequate capitalization enables life insurers to offer policyholders a wide variety of affordable savings and protection products with benefits that can span an entire lifetime. Inadequate capitalization, on the other hand, can result in price increases or restrictions on product offerings and/or benefits that ultimately redound to the detriment of the consumer.

For life insurance companies, regulatory capital is based on the financial statements that are filed with state insurance regulators in the Annual Statement prescribed by the National Association of Insurance Commissioners (NAIC). These Annual Statement financials are based on Statutory Accounting Principles that have been codified and adopted by the states (SAP or statutory accounting).

Federal income taxes affect the statutory accounting financial statements through both current and deferred taxes. However, SAP for income taxes includes a number of restrictions on the recognition of deferred tax assets—far beyond those taken into account under U.S. GAAP—that often leave even temporary difference increases in current taxes without an offset in deferred taxes, resulting in an overall reduction of regulatory capital.

Discussions relating to comprehensive federal income tax reform for corporations have generally focused on “base-broadening” to support a cut in the corporate income tax rate from its current level of 35 percent to somewhere in the 25-28 percent range. To achieve such lower rates on a revenue-neutral basis, base-broadening would have to be quite extensive, with measures affecting businesses in general as well as industry-specific increases. As corporate taxpayers, life insurance companies could be affected in both ways.

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FROM THE EDITOR TO OUR READERS

By Kristin Norberg

The lead article in this issue of *TAXING TIMES* continues our exploration of the February 2014 Tax Reform Discussion Draft released by Dave Camp, then chairman of the House Ways & Means Committee (the Camp Draft). Regular readers will recall that we began analysis of the Camp Draft with a special *TAXING TIMES* Supplement this past October. The supplement addressed many of the direct effects that the Camp Draft would have on insurers and their products if it were to be enacted. In the current issue, Art Schneider and Pete Bautz approach the proposals from another perspective: they explain the indirect effects that the proposals would generally have on insurers' capital positions, resulting from the interaction of the rate reduction and base broadening in the Camp Draft on the one hand, with the NAIC statutory accounting restrictions around recognition of deferred tax assets on the other. This is another important facet of the consideration that companies are giving to the Camp Draft and other recent tax reform efforts.

For those not yet ready to tackle the alphabet soup of SSAPs, DTAs, DTLs, RBC, DRD, and DAC, we have a new installment of "In the Beginning... A Column Devoted to Tax Basics" to get you started! In this edition, Stephen Baker presents some key concepts of tax and statutory accounting, including common permanent and temporary differences between statutory income and taxable income for life insurers. Book-to-tax differences underlie almost all company-focused topics we discuss in this newsletter (including the deferred tax issues in the lead article), and it is beneficial for all actuaries to have an understanding of the concepts and terminology in this area.

The rest of the issue addresses a number of current happenings, from rulings in both the life and non-life space, to new regulations that would make a cost-effective longevity protection product feasible in qualified retirement arrangements, to an update on which topics the Internal Revenue Service and Treasury Department have identified as priorities for developing published guidance in the upcoming year. As always, we thank all of our authors and editors for their valuable contributions to the work of the Taxation Section and *TAXING TIMES*, and we hope you enjoy reading the issue!

FROM THE CHAIR

By Tim Branch

If I had been asked at the start of my actuarial career where I thought I would be at this point, I can guarantee you the answer would not have been “Taxation Section Council Chair.” I’m pretty sure I didn’t even know such a thing existed at the beginning of my career. But here I am, and I’d like to thank everyone who helped me to get here. I’d like to extend special thanks to the Taxation Section Council members, both past and present, for their generosity with both their time and knowledge. I’d also like to thank Brenna Gardino, our outgoing chairperson, for her leadership over the past year. And finally I’d like to thank Dave Carlson for giving me the opportunity to become a tax actuary (or “taxuary,” as he calls us) in the first place.

Tax is an often overlooked, yet very important part of our work as actuaries. Taxes touch every aspect of an insurance company’s operations; product development, financial reporting, capital planning, reinsurance, policy holder reporting, and mergers and acquisitions, to name a few.

Unfortunately, it is not uncommon for actuaries to simplify or ignore the impact of taxes. Often, taxes are simply thought of as a 35 percent reduction to earnings, without considering current tax versus deferred tax impacts or a company’s particular tax fact pattern. While a 35 percent adjustment may sometimes be a passable “back-of-the-envelope” approximation of tax, it is important to consider the materiality of tax for the intended purpose. For example, it would not be appropriate to determine the tax impact of selling a block of business by multiplying the purchase price by 35 percent. It should be our goal as a section to increase the general “tax IQ” of actuaries, through the continued publication of *TAXING TIMES*, presenting tax-focused sessions at Society of Actuaries meetings, and within our companies.

We should also be educating new actuaries just entering the field on tax issues. We need to make sure our actuarial colleagues are paying attention to tax, and including appropriate tax adjustments in their work. And finally, we should make sure we are not just talking tax to other actuaries, but to our friends in accounting, underwriting, risk management, investments and capital planning (to name a few).

In addition, tax reform is on the horizon, and we will need to keep a close watch on the proposals that impact the insurance and retirement services industries. As actuaries, it is up to us to monitor the changes that have actuarial consequences, and be aware of the impacts to our companies and clients, as well as the industry as a whole. The last significant tax reform to impact the life insurance industry occurred 30 years ago with the enactment of the Deficit Reduction Act of 1984 (DEFRA) and the Tax Reform Act of 1986. Much can be learned from the tax professionals who helped guide the industry through those changes, and we should make sure to download as much of their knowledge as possible. Educating the next generation of “taxuaries” is critical; we will have big shoes to fill in this next round of tax reform. Our predecessors have laid the groundwork for the current tax regime, and now it is up to us to continue to be a part of future tax reform discussions.

To recap: every actuary should understand how tax impacts their work. It is our job as members of the Taxation Section to help educate our fellow actuaries and colleagues on the importance of tax. After all, nothing in the world is certain, except for death and taxes (and possibly the Taxation Section). ◀

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Note: The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

This article will explore the potential impact of corporate tax reform on the life insurance industry. More specifically, it will focus on the possible effects of tax reform on life insurance company regulatory capital through its impact on statutory accounting for income taxes, and on the ultimate ability of life insurers to offer affordable savings and protection products. It will start with a brief discussion of the importance of capital to the life insurance industry. It will then examine the impact of accounting for income taxes on life insurance companies' capital. That will be followed by a discussion of the tax accounting and capital effects of various recent proposals that were targeted at the life insurance industry, and an illustration of the potential impact on life companies' returns on equity (ROEs) if similar proposals were to be enacted. The article will conclude that the potentially significant adverse effect of such proposals on life insurance companies' regulatory capital could require companies to re-evaluate the availability, design and pricing of their protection and savings products.

IMPORTANCE OF CAPITAL TO THE LIFE INSURANCE INDUSTRY

Life insurance is a business that has historically been regulated by the states. As noted in the introduction, under state regulations, the primary financial reporting method for life insurance companies is statutory accounting in the Annual Statement blank approved by the NAIC. Statutory accounting is significantly different from U.S. GAAP reporting. It is required for all life insurance companies and is not used by other non-insurance companies. Many small or mutually-owned or internationally-owned insurers do not even prepare GAAP financial statements.

An important component of the statutory accounting financial reporting system is regulatory capital. This metric is used to judge the financial health of life insurance companies, as well as assess the ability of companies to write new business. Lower capital amounts adversely impact companies' ability to offer affordable savings and protection products to American consumers. Additionally, life insurance companies are rated by the various credit rating agencies, including Moody's, Standard & Poor's, A.M. Best, and Fitch. Reductions in regulatory capital amounts can affect companies' ratings and cause them to become uncompetitive in writing their products.

There are additional metrics used to measure companies' capital, including risk-based capital (RBC). RBC, calculated according to the NAIC model law, is a method of measuring

the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile. RBC limits the amount of risk a company can take. It requires a company with a higher amount of risk to hold a higher amount of capital. Capital provides a cushion to a company against insolvency. The NAIC RBC ratio is "Total Adjusted Capital" (which is based on Annual Statement capital) divided by "Risk-Based Capital." This ratio provides a means for evaluating the adequacy of an insurer's capital relative to the risks inherent in the insurer's operations. The NAIC RBC requirements are intended to capture several forms of risk facing insurance companies. For life and health insurers, these risks include asset risk, insurance risk, interest risk and business risk.

RBC ratios are a key index used by both regulators and rating agencies to assess the financial strength of insurance companies. In recent years, and certainly since the 2008 financial crisis, regulators and rating agencies have sought higher levels of capital for insurers to run their businesses. This can be seen in the significant growth of life industry RBC levels. The average NAIC RBC level for life insurers in 2013 was nearly 50 percent higher than in 2002.

In the wake of the financial crisis, factors such as low interest rates and greater volatility in the equity markets have led companies not only to buffer their capital levels, but also to enhance risk and capital management, with the overall goal of reducing the capital intensity of their businesses. Actions such as scaling back on guaranteed benefits, making product design changes, exiting certain product lines, cutting expenses, increasing the use of hedging, and de-risking of asset portfolios all are aimed at increasing the quality of capital in line with demands from regulators, rating agencies and consumers.

IMPACT OF ACCOUNTING FOR INCOME TAXES ON LIFE INSURANCE COMPANIES' CAPITAL

Federal income taxes affect Annual Statement Capital and Surplus (and therefore Total Adjusted Capital and the RBC ratio) in two ways:

- Current year estimates of federal income taxes payable or recoverable are recorded based on tax returns for the current and prior years (including tax loss contingencies); and
- Deferred tax assets (DTAs) and deferred tax liabilities (DTLs) are recorded on temporary differences, subject to limitations (discussed below) on recognition of DTAs.

SAP are codified in the NAIC Accounting Practices and Procedures Manual which includes the Statements of Statutory Accounting Principles (SSAPs) that have been adopted by the NAIC. SAP utilizes the framework established by U.S. GAAP, but with modifications designed to address the concerns of insurance regulators, who are the primary users of the statutory financial statements. Statutory accounting for income taxes, as set forth in SSAP No. 101, is therefore based on U.S. GAAP accounting for income taxes (ASC 740), but with a number of significant modifications.

Following major revisions to the federal income tax rules governing taxation of life insurance companies in the Deficit Reduction Act of 1984 and the Omnibus Budget Reconciliation Act of 1990, life insurance companies have consistently been in a net DTA position for statutory accounting purposes. A net DTA position means companies have recognized taxable income at an earlier time than the same income is recognized for book accounting purposes. For life insurers, two primary differences are: 1) tax reserves being lower than statutory reserves; and 2) certain policy acquisition costs being capitalized for tax purposes (tax DAC) that are expensed for statutory purposes. (These and other differences between tax accounting and book accounting are described in this issue's "In the Beginning..." column, on page 11.) In either case, life insurance taxable income exceeds statutory income, resulting in DTAs. Unlike GAAP, which often allows full recognition of deferred tax assets, SSAP 101 imposes a number of restrictions on recognition (admissibility) of DTAs.² Non-recognition of DTAs, which, as discussed below, is much greater for statutory accounting than for GAAP, results in a net decrease in statutory equity because cash taxes out the door cannot be fully offset if DTAs are not recognized.

If all or part of an asset, including a DTA, is not admitted, whatever is non-admitted cannot be included in the life insurer's regulatory capital. But even before getting to the admissibility tests, SSAP 101 requires that gross DTAs be reduced to the amount that is more likely than not to be realized. This amount is referred to as adjusted gross DTAs. Adjusted gross DTAs are then admitted based upon a three-component admission calculation set forth in paragraph 11 of SSAP 101:

- First, DTAs may be admitted to the extent a company has paid taxes in prior years that could be recovered through loss carrybacks for DTAs that reverse during a timeframe



corresponding with loss carryback provisions of the Internal Revenue Code, not to exceed three years (SSAP 101, paragraph 11a).

- Under a second admissibility test, DTAs may be taken into account only to the extent they reverse in the subsequent three years (SSAP 101, paragraph 11b).³
 - The amount "expected to be realized" from these three-year reversals is determined through a calculation of the company's projected income tax liability in the subsequent years "with and without" the reversing DTAs. Accordingly, projected income may further limit the admissibility of DTAs if it is not adequate to produce a "with and without" tax benefit.
 - The amount expected to be realized is reduced by the amount admitted under the first admissibility test, and then subjected to a possible further limitation based on 15 percent of the company's adjusted statutory surplus.
- Under a third admissibility test, DTAs may be admitted to the extent they can be offset against DTLs (SSAP 101, paragraph 11c).
 - DTLs must be recorded in any event.
 - If DTLs are not fully offset by DTAs, the result is a further decrease to regulatory capital.

The upshot of these admissibility tests is that net DTA recognition—and thus inclusion of DTAs in regulatory capital—is very limited under statutory accounting for life insurance companies and often covers, at best, only the DTA amounts that

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reverse over the succeeding three years. Given that 1) capitalized tax DAC is amortized over 10 years, 2) tax versus statutory reserve differences reverse over the life of the business—which may be a very long period of time, and 3) life insurers’ attempt to match the duration of their investment assets with the life of their policyholder liabilities—a substantial portion of net DTAs reverses beyond three years and therefore remains unrecognized. For example, for the year ended Dec. 31, 2013, the industry-wide non-admitted DTA was \$42 billion, or about 38 percent of the \$111 billion gross DTA and about 50 percent of net DTAs (after offsetting DTLs).

An over-simplified example can illustrate these principles. Assume that, for the year ended Dec. 31, 2014, life insurance company L estimates that it will pay \$35 of federal income tax on \$100 of current taxable income. Assume also that L has paid the same amount of taxes for each of the two prior years ending Dec. 31, 2012 and 2013. Further assume that at the end of 2014 L has a \$1,000 adjusted gross DTA temporary difference for tax DAC, another \$600 adjusted gross DTA temporary difference for reserves, and no DTLs. Of these temporary difference amounts, \$300 of the DAC and \$100 of the reserves are expected to reverse in the succeeding three years. L projects that in each of the 3 succeeding years it will have \$200 of current taxable income before reversal of the DAC and reserve temporary differences.

Using the with-and-without calculation, L determines that it will pay tax of \$210 in the succeeding three years ($3 \times \$200 = \$600 \times 35 \text{ percent} = \210) without the DTA reversals, and \$70 ($\$600 - \$300 - \$100 = \$200 \times 35 \text{ percent} = \70) with the reversals. (This calculation is actually done on a year-by-year basis—it has been compressed in the example for ease of presentation). Of this amount, \$105 (the \$35 of current tax for each of the years ended Dec. 31, 2012, 2013 and 2014) can be admitted under SSAP 101 paragraph 11a. The remaining \$35 ($\$140 - \105) can be admitted under paragraph 11b. If L’s “without” tax for the period 2015-2017 had been \$105 or less, no additional DTA would be admitted under paragraph 11b. Similarly, if 15 percent of L’s adjusted capital and surplus was less than \$35, the DTA admitted under paragraph 11b would be limited to that lesser amount.

TAX ACCOUNTING AND REGULATORY CAPITAL EFFECTS OF POTENTIAL TAX REFORM PROPOSALS ON LIFE INSURERS

Tax law changes affect statutory financial statement account-

ing for income taxes in a number of ways:

- Changes in permanent differences affect current tax expense and, by themselves, have no offset in deferred taxes.
- Changes to or creation of new temporary differences affect current tax expense and, as noted above in the discussion of DTA admissibility, may not be fully offset in deferred taxes.
- Enacted tax rate changes must be reflected in DTAs and DTLs at the time of enactment.
- Future income is taxed at the newly-enacted rates.

As noted above, corporate tax reform discussions generally contemplate a reduced corporate tax rate funded by both general corporate and industry-specific base-broadeners to accomplish the reform on a revenue-neutral basis. If base-broadening proposals with respect to the life insurance industry resembled those contained in the February 2014 Tax Reform Discussion Draft released by Rep. Dave Camp, Chairman of the House Ways & Means Committee (the Camp Discussion Draft or the Camp Draft), they might be centered on reserves and tax DAC, because that is where the biggest revenue effects would be. Another possible life insurance company-specific proposal is further limitation on the dividends received deduction (DRD).⁴

These changes could have a significant adverse impact on the regulatory capital (and therefore, the RBC ratios) of the life insurance industry:

- Modification of the DRD rules would result in a permanent tax increase that would increase current tax expense and that could never be recouped.
- Changes in the computation of life insurance tax reserves and in tax DAC capitalization would increase current tax expense, resulting in greater DTAs, of which only a portion could be recognized for statutory accounting/regulatory capital purposes.
 - Furthermore, if the tax rate cut was phased-in over time, there would be a permanent tax increase resulting from greater DTA temporary differences taxed at a higher rate during the phase-in period that would reverse in later years at a lower rate as the rate cut was fully phased-in.
- The tax rate cut would also result in an immediate decrease in statutory surplus as admitted DTAs would have to be restated at the lower corporate tax rates.

Other corporate tax reform proposals (e.g., general corporate base-broadeners or limitations on loss carrybacks) also could

have adverse impacts on life company regulatory capital. Given the adverse effect of base-broadeners, and the limited recognition afforded to DTAs, it is likely that corporate tax reform would result in companies being worse off from a statutory accounting standpoint (current and deferred taxes combined) for many years in the future.

SCENARIOS ILLUSTRATING ADVERSE IMPACT OF CAMP DRAFT ON LIFE INSURERS' CAPITAL

The Camp Discussion Draft contained detailed proposals for both individual and corporate tax reform. The Camp Discussion Draft proposals were given extensive coverage in the October 2014 supplement to *TAXING TIMES*. For purposes of the following discussion, the key proposals in the Camp Draft include:

- Corporate tax reduction from 35 percent to 25 percent, phased-in 2 percent per year over a year-year period.
- Repeal of corporate alternative minimum tax.
- Substantial increase in tax DAC capitalization rates, especially for annuities.
- Change to the tax reserve discount rate, resulting in lower tax reserve deductions.
- Further reduction of the DRD.
- Reduction of the life company loss carryback period from three years to two (to conform to the period allowed other corporate taxpayers) and limitation of the loss carryback to 90 percent of taxable income in the carryback year.
- General corporate base-broadeners.

These proposals were estimated to result in more than a \$2 increase in life insurance company taxes for each \$1 of benefit over the 10-year revenue window used for scoring changes to the federal income tax law.

The following discussion considers four different scenarios of current and statutory deferred tax calculations under existing law and under the Camp Draft proposals. The calculations extend over the 10-year revenue window, assuming the Camp proposals became effective in 2015 as proposed in the Discussion Draft. In line with the Camp Draft, the scenarios assume a significant increase in current tax expense which reverses in part over a period of years.⁵

Although these scenarios are hypothetical, and consider only a few of the myriad positions that life insurance companies could find themselves in, the following conclusions can be drawn:

- No matter what situation life insurance companies are currently in with regard to recognition of statutory DTAs, they would be likely to recognize substantial decreases in statutory surplus if the proposals in the Camp Discussion Draft became law, driven by:
 - Substantial increases in current tax expense from life insurance company-specific and general corporate base-broadeners that far outweigh the expected benefits of the corporate tax rate cut.
 - Limited ability to offset current tax expense with deferred tax benefits because of:
 - No offset in deferred taxes for increases in current tax resulting from changes in permanent differences such as:
 - Reduction in the DRD.
 - DTAs originating at higher tax rates and reversing at lower tax rates.
 - Restrictions on statutory DTA recognition to only those that reverse in the succeeding three years.
 - As a simplified example, in the case of DAC capitalization and amortization, the best result that the company could have (in the absence of tax planning strategies) would generally be additional DTA recognition for approximately 30 percent of the additional current tax expense.
 - Further restrictions on DTA recognition that can



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result in admission of a lower amount of DTAs than the amount expected to be realized by the three-year reversals.

- This effect would be exacerbated by the Camp Discussion Draft's limitations on ordinary loss carrybacks, which generally would reduce the amount of DTA recognition under paragraph 11a of SSAP 101, thereby putting greater stress on recognition under paragraph 11b, to which the additional limitations apply.
- In some cases, the increase in projected future taxable income driven by the base-broadeners in the Camp proposal could result in greater DTA recognition than under current law, but that effect would still likely be outweighed by the adverse effects of the increase in current taxes.
- The tax rate cut, while producing a current tax benefit, would produce a deferred tax detriment as it reduces the value of admitted DTAs.

Scenario 1

Scenario 1 considers a life insurance company that currently is able to recognize a DTA for all of its three-year reversals under the first admissibility test (SSAP 101, paragraph 11a).

- The company in this case would no longer be able to admit all of its three-year reversals under paragraph 11a if the Camp Discussion Draft was enacted (because only the first two years of reversals could be carried back and when carried back could offset only 90 percent of taxable income in the carryback year).
 - Accordingly, the company would incur a decrease in surplus at 12-31-14 as the amount expected to be realized from the three-year reversals would be based on the lower tax rates enacted for future years.
 - This is true even if the first two years of the 3-year reversals are fully or partially recognized under paragraph 11a at the old 35 percent tax rate, because the amount recognized under 11a is subtracted from the amount expected to be realized (which is computed using the new, lower tax rates) to determine the amount recognizable under paragraph 11b.⁶
- In future years, there would be a benefit in current tax expense from the tax rate cuts, but that benefit would likely be far outweighed by the specific life insurance company and general corporate base-broadeners in the Camp Discussion Draft.
 - The result would be an increase in current tax expense

(and reduction of surplus) for future years.

- This increase in current tax expense would either provide no benefit in deferred taxes (e.g., a permanent adjustment like the decrease in the DRD), or would only provide a very limited deferred tax benefit (e.g., for timing differences like DAC and reserves).
 - DAC reverses over a 10-year period and reserves generally reverse over an even longer period, and only the first three-years of reversals can be taken into account under SSAP 101.
 - Meanwhile, DTAs that would have reversed and been recognized at 35 percent under the old law would reverse and be recognized at lower tax rates under the new law.
 - The result in this case would be a decrease in admitted DTAs for future years.
- Accordingly, the company in this case not only would not be able to offset the increase in current tax expense against deferred tax, but actually would suffer surplus decreases from both increased current tax expense and decreased DTA recognition for the foreseeable future.

Scenario 2

Scenario 2 considers a life insurance company that currently is able to recognize a DTA for all of its three-year reversals under a combination of the first and second admissibility tests (SSAP 101, paragraphs 11a and 11b).

- That is, the company is not limited in the second admissibility test by projected future income or by the 15 percent of surplus limitation.
- This company would suffer a surplus decrease at 12-31-14 for the same reasons as the company in the first scenario.
- Likewise, in future years, this company would suffer surplus decreases from both increased current tax expense and decreased DTA recognition for the foreseeable future.

Scenario 3

Scenario 3 considers a life insurance company that currently is limited in its recognition of DTAs under SSAP 101, paragraph 11b, because its projected future taxable income is less than its deductible temporary differences that reverse during the next three years.

- At 12-31-14, the company in this scenario would recognize a surplus benefit from greater admissibility of DTAs.
 - The company would admit a lower amount of its three-year DTA reversals under paragraph 11a (because of the two-year carryback and the 90 percent limitation),

thereby putting greater stress on the second admissibility test and the limitations that apply thereto.

- However, the company would project substantial increases in future taxable income (as a result of the life insurance company and general corporate base-broadeners) that would enable it to admit more DTAs under paragraph 11b despite the enacted tax rate reductions.⁷
- This deferred tax benefit would continue into the future, but would likely be offset by and ultimately outweighed by the increased current tax expense.
- Thus, while the company in this scenario would not suffer the combined adverse surplus impact of both increased current tax expense and decreased DTA recognition (like the companies in scenarios 1 and 2), it nevertheless could incur a reduction in surplus.

Scenario 4

Scenario 4 considers a life insurance company that currently is limited in its recognition of DTAs under SSAP 101, paragraph 11b, because 15 percent of its surplus is less than the DTAs that would otherwise be admissible under 11b (whether or not already limited by projected future income).

- At 12-31-14, the company would suffer a surplus reduction resulting from the two-year carryback and 90 percent of taxable income limitations under the Camp proposal.
 - Any reduction in the amount of DTAs recognizable under paragraph 11a would result in a direct hit to surplus as the limitation under paragraph 11b would not change.
- In future years, this negative impact to surplus would likely continue.
 - Although the amount recognizable under paragraph 11a would increase as the base-broadeners in the Camp tax proposal took effect (and offset the benefit of tax rate decreases), the two-year carryback and 90 percent of taxable income limitations would continue to reduce the amount recognizable under paragraph 11a as compared to current law.
 - Furthermore, the increase in current tax expense would be a reduction of surplus that is taken into account in the 15 percent of surplus limitation on the amount recognizable under paragraph 11b.
 - In other words, an increase in current tax expense, rather than producing a deferred tax benefit, would actually create a further 15 percent negative effect on surplus through reduction of admissible DTAs.
- So, for different reasons but with similar effect to the companies illustrated in Scenarios 1 and 2, the company in this case would

suffer surplus reductions in future years, resulting both from increased current tax expense and decreased DTA recognition.

EXAMPLE ILLUSTRATING ADVERSE IMPACT ON ROE

Like other corporations, life insurance companies must create value for their shareholders. For a capital-intensive business such as life insurance, return on equity (ROE) is a key metric. ROE is a financial ratio determined by dividing after-tax net income by shareholder's equity. For example, if a company has pre-tax income of 100, tax of 35, and shareholder's equity of 650, its ROE would be $65/650 = 10$ percent.

ROE is also a key metric in the pricing of life insurance and annuity products. In general, an increase in capital requirements for a particular product could be expected to cause some combination of:

- Higher prices charged to consumers to maintain the same ROE.
- Lesser product benefits.
- Lower ROEs.
- Lesser availability of products if companies are no longer able to earn minimum acceptable ROEs.

The example below illustrates the potential effects of the Camp proposal on ROEs. The point is to demonstrate that if after-tax returns go down (as a result of higher taxes) while invested equity goes up (to maintain statutory capital at a level necessary to preserve ratings), then ROE must fall.

- If the only effect of tax reform on life company taxation was a decrease in the corporate tax rate from 35 percent to 25 percent, then the company's ROE could be expected to increase to 11.5 percent (100 pre-tax income less 25 tax = 75 ; $75/650 = 11.5$ percent).
- However, as discussed above, the Camp proposal would raise taxes on the life insurance industry by more than two times the benefit of the tax rate cut.
- In addition, as also discussed above, the corporate tax rate cut would have the effect of decreasing the life insurance company's statutory admitted DTAs, thereby reducing statutory capital.
- So, assume the tax on 100 of pre-tax income increases by 10 (to 45) as a result of the Camp tax proposal, rather than being reduced by 10.
 - Of this amount, assume that the company's statutory admitted DTA increases by 3, so the net effect of taxes is a decrease of 7 in statutory capital.

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- Assume also that statutory capital includes admitted DTAs of 105, which would be reduced to 75 when the tax rate is cut to 25 percent.
- Also assume that to maintain its ratings, the company determines that it must replace the 37 of capital decrease resulting from the Camp tax proposal.
- To maintain an after-tax return of 10 percent, the company must now earn after-tax profits of $68.7((650+37)*10\text{ percent})$.
 - 650 of the invested capital continues to produce 100 of pre-tax profit, but only 55 after-tax profit.
 - The 37 of additional invested capital produces an after-tax investment return of, say, 4.6 percent, or 1.7.
 - The remaining 12 of after-tax profit needed to maintain ROEs at 10 percent must come through price increases or benefit reductions.

- If ROEs cannot be maintained, the company may discontinue issuing the product.

CONCLUSION

The significant adverse effect that tax reform proposals could have on life insurance companies' regulatory capital would require companies to have to re-evaluate the availability, design and pricing of their protection and savings products. In some cases, companies might choose to not offer certain products, to reduce the benefits provided by these products, or to increase the price of these products to achieve required returns. Any of these steps would adversely impact policyholders. ◀

END NOTES

- ¹ A temporary difference is a difference between the tax basis of an asset or a liability and its reported amount in the financial statements that will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. A DTL is recognized for temporary differences that will result in taxable amounts in future years. A DTA is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards (e.g., of losses and credits).
- ² Because DTLs are recognized in any event while DTA recognition is limited, deferred tax accounting cannot result in a net benefit to the statutory financial statements. Even if not limited, full recognition of DTAs would only mean that a company is able to recognize an asset that offsets the current tax that it has "prepaid" because of tax law differences from book accounting.
- ³ Companies with low RBC levels may be limited to 1-year reversals, or even no reversals in some cases.
- ⁴ While unique to the life insurance industry, these base-broadeners cannot be considered "loopholes" or special deductions that normally would be targeted by tax reform to finance a rate cut. Reserve deductions are necessary to prevent unwarranted acceleration of taxable income. DAC and limitations on the DRD actually are detriments suffered by life insurers under current law that are not applicable to non-insurance companies. It is arguably inappropriate for tax reform proposals to target any of these items for even harsher treatment.
- ⁵ A portion of the current tax increase is assumed to be attributable to permanent differences which do not reverse.
- ⁶ In rare cases, the amount recognizable under paragraph 11a may exceed the amount expected to be realized from all three-year reversals. In that case, the higher amount is recognizable under 11a and zero is recognizable under 11b.
- ⁷ The company in this situation could find its DTAs subject to the 15 percent of surplus limitation rather than projected income, thereby limiting the deferred tax benefit described above.

IN THE BEGINNING... TAX ACCOUNTING FOR INSURANCE COMPANIES

By Stephen R. Baker

One of the key tasks insurance company tax departments have in carrying out their financial reporting obligations is managing the interplay of financial statement, or “book,” accounting and tax accounting. An insurance company may have multiple reporting obligations, requiring different accounting rules depending upon the type of organization it is—e.g., a stock versus a mutual insurance company—and the intended recipient of the financial report—e.g., a shareholder or a state regulator. This piece discusses, among other things, the major reporting systems insurance companies are required to apply, the interplay between tax and book accounting, and a few of the more common differences among these accounting systems.

INSURANCE ACCOUNTING METHODS

The primary financial statement prepared by domestic insurance companies is intended for state insurance regulators. These regulators require insurance companies to prepare financial statements (referred to as the “annual statement” or “statutory annual statement” or “blank” or “statutory blank”) under Statutory Accounting Principles (SAP). The filing submitted under SAP is prepared according to the guidelines of the National Association of Insurance Commissioners (the NAIC), the source of SAP. The type of statement any particular insurance company is required to file is based on industry segment.¹ These statements are highly structured, and all companies within a segment are required to follow the prescribed structure for that segment.

In addition to the required statutory annual statement, an insurance company that is publicly held will be required to prepare financial statements under Generally Accepted Accounting Principles (GAAP) for purposes of reporting to investors and shareholders. These companies will typically also utilize GAAP for purposes of internal reporting. While mutual insurance companies are not required to file GAAP statements, some mutual companies similarly prepare GAAP financials for internal reporting purposes.



If an insurance company is part of an international group headquartered outside of the United States, it may also be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS). SAP, GAAP, and IFRS financial statements and their methods represent the non-tax financial position or “books” of the company and are referred to as “book accounting” methods.

Insurance companies subject to tax in the United States are also required to report the results of their operations to the Internal Revenue Service (IRS). For this purpose, insurance companies are generally required to start with the same method of accounting for tax purposes as they use for statutory accounting purposes. Insurance companies must then make adjustments to account for differences in measurement and treatment of income and expense, or assets and liabilities, between the statutory accounting and federal income tax paradigms.

Typically, these differences are a matter of timing, i.e., when, or how quickly an item is recognized for SAP purposes relative to how it must be recognized for tax purposes. For example, SAP and the Internal Revenue Code (IRC) provide different rules with respect to the period of time over which some assets may be depreciated. The full cost of the asset will eventually be recognized under both methods, but the period of time over which the cost is recovered will differ under each method. This type of difference in timing would be characterized as a temporary difference.

It is also possible that an item may be recognized for book purposes, but never recognized for tax purposes. One example would be tax-exempt interest. This type of difference is referred to as a permanent difference.

STATUTORY ACCOUNTING VS. TAX ACCOUNTING

SAP focuses on the balance sheet, rather than the income statement, and emphasizes insurers’ solvency and liquidity. SAP is developed in accordance with the concepts of

CONTINUED ON **PAGE 12**

consistency, recognition and conservatism. Tax accounting is governed by the rules and principles expressed in the IRC, Treasury regulations, case law, and administrative releases. As stated above, tax accounting often does not agree with book accounting. For example, the “all-events” test provides that:

When all the events have occurred that establish the right of an accrual basis taxpayer to receive a determined or determinable amount, that amount must be accrued or recognized at that time. Where the right to receive income exists currently, the amount can be determined with reasonable accuracy, and the right to receive it isn’t subject to a substantial restriction, the “all events” test is met.²

Hence, although an item may be accrued for book purposes, the subject amount is not recognized for tax purposes until specified conditions are satisfied.

The differences between accounting methods create “book-to-tax adjustments.” The adjustments can increase or decrease what started as SAP (book) income, and they may produce either a temporary or a permanent difference. Further, the adjustments may affect either the current tax year or a later year. Not surprisingly, an adjustment in the current tax year is called a current adjustment. A book-to-tax adjustment that will impact a subsequent tax period is called a deferred adjustment. The accumulation of deferred tax items are called deferred tax assets or deferred tax liabilities, depending upon the direction of the temporary difference.

The following paragraphs highlight some of the differences between tax and annual statement accounting. Please note that the examples have been simplified for illustration purposes and other tax adjustments may also apply.

EXAMPLES OF PERMANENT DIFFERENCES BETWEEN BOOK AND TAX

While there are many permanent differences between book and tax, the list below represents many of the more common differences encountered by insurance companies:

- Tax exempt interest
- Dividends received deduction
- Federal income tax paid
- Tax, criminal and other penalties
- Meals and entertainment
- Lobbying expenses

EXAMPLES OF TEMPORARY DIFFERENCES BETWEEN BOOK AND TAX

For annual statement purposes, insurance companies are required to accrue certain expenses and losses in years in which they may not qualify as income tax deductions, or to recognize certain income items at different times. These include but are not limited to:

- Advance premiums
- Deferred and uncollected premiums
- Agents’ debit balances
- Impairment of assets
- Reserve strengthening or weakening
- Policy acquisition expenses

One of the temporary differences most familiar to actuaries is the calculation of reserves. Eventually, every reserve will revert to zero once the obligations under the contract have been fulfilled. By governing the level of the reserve over the life of the policy for their respective methods, book and tax accounting affect how quickly profits emerge under each paradigm.

The table on page 13 illustrates the effects of several common permanent and temporary differences in calculating the book and tax net income of a life insurance company.

CONCLUSION

This piece has merely highlighted the existence of several types of accounting regimes that insurance companies must manage and discussed some of the many differences that exist between SAP (book) and tax accounting methods. It is important to understand these differences for purposes of both determining the correct amounts to include on a tax return, as well as how (or if) they may be reflected on a financial statement, be it SAP, GAAP, or some other required accounting methodology. ◀

Note: The views expressed are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

	Year 1		Year 2		Year 3	
	SAP	Tax	SAP	Tax	SAP	Tax
Base income common to both accounting methods	10,000	10,000	11,000	11,000	9,000	9,000
Permanent Items						
Tax-exempt interest	300	0	500	0	400	0
Dividends received	200	60	300	90	150	45
Meals and entertainment	(150)	(75)	(150)	(75)	(150)	(75)
Tax penalty	0	0	(75)	0	0	0
Income after Permanent Items	10,350	9,985	11,575	11,015	9,400	8,970
Temporary Items						
Policy issued Y1, lapsed Y3	(100)	(90)	10	8	90	82
Policy acquisition costs for policy issued Y1	(60)	(3)	0	(6)	0	(6)
Income after all items	10,190	9,892	11,585	11,017	9,490	9,046

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END NOTES

- ¹ Different company lines are represented by different color covers on printed annual statements. Life insurance companies file a light blue covered statement and life insurance/annuity separate accounts separately file a green covered annual statement. Examples of other business line colors include: property casualty (yellow), title (salmon), health (orange) and fraternal benefit societies (white).
- ² IRC §451, Treasury Regulation (Treas. Reg.) §1.451-1(a), IRC §461(h)(4) and Treas. Reg. §1.461-1(a)(2).



IRS AND TREASURY RELEASE 2014-2015 PRIORITY GUIDANCE PLAN

By Robert A. Shanahan and Mark S. Smith

On Aug. 26, 2014, the Internal Revenue Service (IRS) and Treasury Department released the Priority Guidance Plan (“Plan”) for 2014-2015,¹ identifying projects on which the IRS and Treasury intend to work actively during the coming year. Each year, the IRS and Treasury formulate a Priority Guidance Plan that focuses resources on published guidance items that are most important to taxpayers and tax administration. Issues that are identified on the Plan may be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The Plan is aspirational in the sense that it does not place any deadline on the completion of projects. The Plan contains 317 projects, including seven items that are specific to insurance companies and products.

Last year’s Plan² included nine insurance-specific projects. Five of those projects remain unpublished and carried over to the 2014-2015 Plan:

- Final regulations under section 72 on the exchange of property for an annuity contract. Proposed regulations were published on Oct. 18, 2006;
- Guidance on annuity contracts with a long-term care insurance rider under sections 72 and 7702B;
- Guidance clarifying whether the Conditional Tail Expectation Amount computed under AG 43 should be taken into account for purposes of the reserve ratio test under section 816(a) and the statutory reserve cap under section 807(d)(6);³
- Guidance on exchanges under section 1035 of annuities for long-term care insurance contracts; and
- Regulations under section 7702 defining cash surrender value.⁴

Three projects on the 2013-2014 Plan were addressed in published guidance:

- Revenue Ruling 2014-15,⁵ which concluded that an arrangement between a voluntary employees’ beneficiary association (VEBA) and a captive insurer to provide med-

ical coverage to retirees of the captive’s parent qualified as insurance;

- Revenue Ruling 2014-7,⁶ which effectively revoked the approach of Rev. Rul. 2007-54⁷ to determine the company’s share of net investment income and, hence, the company’s dividends-received deduction; and
- Final regulations section 1.833-1, which establishes the method to be used by Blue Cross Blue Shield entities in determining the medical loss ratio (MLR) required by that section.⁸

One insurance project from the 2013-2014 Plan was closed without publication. That project would have addressed which table to use under section 807(d)(2) when more than one table in the 2001 CSO mortality table meets the requirements of that section. Although no reason was given for not publishing that item, it is widely believed that the issue is adequately addressed by existing guidance. The IRS will have another opportunity to consider mortality table transition in the context of life principle-based reserves (PBR).

In addition to the five projects that carried over from the prior year, two new insurance projects were added to the 2014-2015 Plan. The first would provide *de minimis* relief for Blue Cross organizations that fail to satisfy the MLR requirement of section 833(c)(5). Section 833 provides special rules that apply only to existing Blue Cross or Blue Shield organizations and certain other organizations. For example, unlike other nonlife insurers, such organizations are not required to apply a 20 percent haircut to their unearned premium reserve, and are eligible for a “special deduction” if certain computational requirements are met. Such organizations also are treated as stock insurance companies without regard to the percentage of their business that is represented by the business of insurance. In order to qualify for the benefits of section 833, an otherwise-eligible organization must maintain an MLR of at least 85 percent. Although regulations published early in 2014 declined to adopt commentators’ suggestions to provide a remedy for *de minimis* failures to satisfy this requirement, the

preamble to those regulations provided that “[t]he Treasury Department and the IRS continue to consider whether, and, if so, how to permit organizations to address *de minimis* failures to satisfy the MLR under section 833(c)(5).”⁹

The second, and potentially more important, new project on the 2014-2015 Plan would provide guidance relating to captive insurance companies. The Plan does not provide more information about this item. It is possible the item was added to the Plan in response to the IRS’s loss in *Rent-A-Center v. Commissioner*,¹⁰ in which the Tax Court concluded that an arrangement qualified as insurance, notwithstanding factors (such as a relatively small number of policyholders) that the IRS has historically cited as disqualifying.¹¹ It also is possible that the item is in response to a perception on the part of some at IRS that some companies claiming the benefits of section 831(b) are not so entitled. Or, it is possible that the item is in response to a June 12, 2014, letter from Sen. Ron Wyden to Secretary Lew and Commissioner Koskinen concerning the taxation of some offshore reinsurers that are owned by hedge funds. That letter led, in turn, to an exchange of letters between Chairman Wyden and the Treasury Department,¹² and a Joint Committee document providing further information on the issue.¹³ There is no indication to date that the new captive insurance item on the Plan will directly involve life insurers.

As significant as the items that were included in the Priority Guidance Plan are items that were not included. For several years, the American Council of Life Insurers (ACLI) has requested guidance on life PBR, guidance updating the life-nonlife consolidated return regulations, and guidance modifying rules for correcting failures of variable contracts due to inadvertent violations of the section 817(h) diversification rules.¹⁴ Although those items are not included in the formal guidance plan, the IRS may devote resources to those issues and has indicated informally that it continues to study tax issues that arise in connection with life PBR.

The Priority Guidance Plan is typically updated throughout the year, so more items may be added, or more details may be forthcoming on these items in the coming months. ◀

END NOTES

- ¹ Tax Analysts Doc. No. 2014-21047.
- ² Tax Analysts Doc. No. 2013-19474.
- ³ See Edward Robbins, Mark S. Smith, and Peter H. Winslow, “Actuary/Accountant/Tax Attorney Dialogue on Notice 2013-19 and the Statutory Reserves Cap,” *Taxing Times* vol. 9, issue 3 (October 2013); Peter H. Winslow and Christian DesRochers, “Attorney/Actuary Dialogue on Notice 2010-29,” *Taxing Times* vol. 6, issue 3 (September 2010).
- ⁴ See John T. Adney and Alison L. Reynolds, “Whither the Definition of “Cash Surrender Value,”” *Taxing Times* vol. 5, issue 2 (May 2009).
- ⁵ 2014-24 I.R.B. 1095. See also Terrance F. Richardson and Mark S. Smith, “Rev. Rul. 2014-15, The Requirement of Risk Distribution, the Law of Unintended Consequences, and New Questions to Consider in Funding Retiree Health Benefits,” 19 *Taxing Times* vol. 10, issue 3 (September 2014).
- ⁶ 2014-9 I.R.B. 539. See also Susan J. Hotine, “Tidbit: Do We Finally Have Guidance on Separate Account DRD?” 28 *Taxing Times* vol. 10, issue 2 (May 2014).
- ⁷ 2007-2 C.B. 604.
- ⁸ The regulation was added by Treasury Decision 9651, 2014-4 I.R.B. 441.
- ⁹ 2014-4 I.R.B. at 443.
- ¹⁰ 142 T.C. 1 (2014).
- ¹¹ After the Plan was released, the IRS also lost *Securitas Holdings, Inc. v Commissioner*, T.C. Memo 2014-225 (Oct. 29, 2014).
- ¹² See, e.g., Tax Analysts Doc. No. 2014-22273 (Aug. 8, 2014) (letter from Assistant Secretary Alastair Fitzpayne responding to Senator Wyden); Tax Analysts Doc. No. 2014-22274 (Sept. 11, 2014) (letter from Senator Wyden to Secretary Lew).
- ¹³ Tax Analysts Doc. No. 2014-22272 (July 31, 2014).
- ¹⁴ See, e.g., Tax Analysts Doc. No. 2013-10735 (May 1, 2013) (setting forth ACLI requests for the 2013-2014 Priority Guidance Plan).

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FINAL REGULATIONS PAVE THE WAY FOR “QLACs”

By John T. Adney and Bryan W. Keene

Some time ago, the U.S. Treasury Department discovered that participants in qualified defined-contribution plans and individual retirement accounts (IRAs) could outlive their income. Life insurance companies have long marketed annuity contracts as sound retirement planning instruments in the nonqualified market, pointing to the assurance of income for as long as the annuitants survive, and they have provided annuity promises in section 403(b) plans and 408(b) IRAs. However, annuity contracts have not been a universal feature of such popular arrangements as section 401(k) plans and section 408(a) IRAs. The absence of the lifetime income promise, unique to insurer-issued annuity contracts, from the latter types of retirement arrangements began to worry the Treasury, as the absence of any such promise carries negative implications for Americans' retirement security. This is especially true in that defined-contribution plans have steadily replaced the prominent role that defined-benefit plans once held in our private retirement system.

In February of 2010, the Treasury, accompanied by the Internal Revenue Service (IRS) and the Department of Labor, published a request for information on how to facilitate greater availability of lifetime income options in qualified retirement plans (including IRAs). In particular, the request asked for comments on whether changes to the required minimum distribution (RMD) rules under IRC section 401(a)(9) should be made to encourage plan participants to “purchase deferred annuities that begin at an advanced age (sometimes referred to as longevity annuities or longevity insurance).” In response, the life insurance industry and others urged the government to amend those rules to remove impediments to offering deferred income annuities (DIAs) in the qualified market. The typical DIA, unlike a modern deferred annuity contract, provides no cash surrender value (except possibly for a return of premium (ROP) on premature death), but the DIA promises life-contingent annuity payments commencing at a specified age, an option available under all deferred annuities. In this respect, the DIA is a bit of a throwback to earlier times, when insurers sold deferred annuities that lacked surrender values.

Responding to these suggestions, in 2012 the Treasury and the IRS published proposed regulations modifying the RMD rules with this goal in mind.¹ The proposal, which technically was in the form of amendments to the IRC section 401(a)(9) regulations, created a new species of tax critter, the “qualifying longevity annuity contract” or “QLAC.” At base, under the proposal, a QLAC is a form of DIA that provides no cash surrender value as such and under which fixed, life-contingent annuity payments are promised, commencing at a specified age not later than 85. These regulations, subject to a number of changes, were issued in final form on July 1, 2014, effective the next day (when they were published in the Federal Register), and applicable to contracts purchased on or after July 2, 2014. The final regulations, as amended, appear in Treas. Reg. section 1.401(a)(9)-5 and -6 as well as in related rules.

WHY QLACs?

Some background on IRC section 401(a)(9) and the regulations implementing it is likely in order at this point. Those rules require that distributions of a participant's entire interest in a qualified retirement plan or IRA commence by the participant's “required beginning date,” which is generally age 70½. For individual accounts under a defined-contribution plan (including an IRA), the RMD is calculated by dividing the employee's account balance by a life expectancy factor. For this purpose, the account balance of a deferred annuity contract (such as a deferred annuity issued as an IRA) includes the actuarial present value (APV) of certain benefits that are not reflected in the contract's cash value. Because a DIA providing for payments commencing at (say) age 85 obviously has a significant APV but is without a cash value, the APV requirement effectively precluded such a contract from being offered in the qualified plan and IRA markets, since the contract lacked the means to provide RMDs between age 70½ and age 85.

To remedy this conundrum, enabling a qualified plan or IRA to hold a DIA in the form the government deemed appropriate,

the QLAC was born. As amended in July 2014, the RMD rules permit the ownership of a QLAC. Under the final regulations, the value of a QLAC held under a plan or IRA (other than a Roth IRA) is excluded from the account balance used to determine RMDs, meaning that no RMDs would be required with respect to the contract prior to annuity payments commencing thereunder.

WHAT IS A QLAC?

In order to be a QLAC under the final regulations, a contract is required to:

1. Be a commercial, fixed annuity that states in a prescribed manner that it is intended to be a QLAC (see the discussion of “form” and a transition rule below);
2. Limit premiums to the lesser of 25 percent of the participant’s account balance or \$125,000, indexed for inflation in \$10,000 increments;
3. Specify an annuity starting date (ASD) that occurs by (or shortly after) the participant’s age 85;
4. Provide no cash surrender value, commutation benefit, or other similar feature;
5. Provide annuity payments that otherwise comply with the applicable RMD rules; and
6. Limit any death benefits provided to certain forms of survivor annuity payments or to a lump-sum ROP within certain limits.

The final regulations also set forth certain disclosure and annual reporting requirements applicable to QLACs. Some detail on this list of requirements follows, in the order of the requirements just listed.

Form. The final regulations require a QLAC to state, on its face or in a rider or endorsement (or in a group contract certificate), that it is intended to be a QLAC. Since DIA contract forms otherwise complying with the QLAC rules will need to undergo an amendment process to implement this requirement, the final regulations include a transition rule addressing them. Pursuant to this rule, a contract issued before Jan. 1, 2016, that does not comply with this form requirement will nonetheless be treated as complying if it is amended to com-

ply by the end of 2016 and the contract owner was notified at issuance that the contract was intended to be QLAC.

Premium limits. The premium limits are subject to certain aggregation rules. The \$125,000 limit measures premiums paid for QLACs in all qualified retirement arrangements in which the individual participates—employer-sponsored plans, IRAs, etc. The 25 percent limit applies separately to employer plans and IRAs, but for this purpose all the IRAs that an individual owns are aggregated when applying the limit. In response to industry comments, the final regulations also provide a mechanism for correcting excess premium payments, *i.e.*, by returning them to the participant’s account by the end of the following year. This can be accomplished by returning the excess premium in cash or as an annuity contract that is not intended to be a QLAC. Premiums paid for a noncompliant QLAC (other than one that fails the premium limits) do not count toward the premium limits applicable to QLACs. Further, for purposes of applying the 25 percent limit, the regulations provide that the value of a QLAC is included in the account balance even though it is otherwise disregarded in applying the RMD rules, thus eliminating a technical problem that could have arisen in the case of QLACs purchased with multiple premiums. In addition, the regulations say that the 25 percent limit is applied to the account balance as of the last valuation date preceding the date of a premium payment, adjusted for subsequent contributions and distributions. For IRAs, the 25 percent limit is applied to the prior year-end account balance of all the individual’s IRAs.

Death benefits. As noted above, under the final regulations a QLAC (to be a QLAC) must limit any death benefit it provides to (1) life-contingent survivor payments or (2) a lump sum ROP. For spousal beneficiaries, the regulations allow a QLAC to provide both a survivor annuity and an ROP benefit, but for non-spouse beneficiaries only one or the other is allowed. If a QLAC provides for a survivor annuity to a non-spouse beneficiary in lieu of a lump sum ROP, the contract must either provide no benefit at all if the participant dies before the ASD or the beneficiary must be irrevocably elected by the later of the participant’s required beginning date or the date the QLAC is purchased. In either case, the survivor annuity payments to the non-spouse beneficiary must be reduced by a factor prescribed in one of two tables set forth in the regulations. If an ROP death benefit is payable to a spouse or non-spouse beneficiary, it must be distributed from the plan or IRA by Dec. 31 of the year following death. Further, if the

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participant (or spouse) dies after his or her required beginning date, the ROP death benefit is treated as an RMD for the year in which it is paid and is not eligible for rollover, meaning that it will be forced out and be taxable to the beneficiary.

Disclosure requirements. The final regulations require QLAC issuers to file annual calendar-year reports with the IRS and provide a statement to the participant regarding the contract’s status, including in the reports the fair market value of the QLAC. The preamble to the final regulations states that the annual reporting requirement “will be similar to the annual requirement to provide a Form 5498, ‘IRA Contribution Information,’ in the case of an IRA.” The IRS has released a new reporting form, Form 1098-Q, “Qualifying Longevity Annuity Contract Information.” According to the new form, the QLAC issuer is to send the form to the participant beginning with the first year in which premiums are paid for the QLAC and ending with the year in which the participant attains age 85 or dies (whichever is earlier).

THE LIMITATION TO FIXED ANNUITIES

The final regulations, like the proposed regulations before them, prohibit the use of a variable annuity, indexed annuity, or similar contract as a QLAC. The life insurance industry had asked, in commenting on the proposed rules, that such products be allowed, for example, to provide a guaranteed “floor” of payments with the potential for increases based on mortality or investment gains (or expense savings), a specified index, or a referenced pool of assets. Although the final regulations allow QLACs to be structured as participating contracts or to provide for certain cost-of-living increases in payments, they largely punted on the use of variable or indexed annuities by retaining the general prohibition against their use as QLACs but delegating authority to the IRS to publish guidance with exceptions to that prohibition.

Why such a prohibition? The preamble to the final regulations explains that the Treasury and IRS believe that QLACs should provide “a predictable stream of lifetime income” and that variable annuities and indexed annuities “provide a substantially unpredictable level of income ... even if there is a minimum guaranteed income.” The preamble also points to a desire for “a limited set of easy-to-understand QLAC options” to improve “the ability of employees to compare the products of multiple providers.” Of course, variable annuities and indexed annuities can be structured to provide a “predictable stream of lifetime income,” so it may just be a matter of

the industry continuing to educate the government on this fact, enabling the IRS to publish the guidance that the regulations suggest may be forthcoming.

STILL MORE TO COME?

The final regulations enabling the issuance of DIAs as QLACs take a major step in the right direction, enabling qualified defined-contribution plans and IRAs to provide an income to participants and their beneficiaries that they cannot outlive. The regulations, however, do not reach an even older style of retirement plan—the defined-benefit pension plan. The Treasury, to its credit, is aware that the purchase of DIAs could benefit such plans as well. To this end, the preamble to the final regulations requests comments on “the desirability of making a form of benefit that replicates the QLAC structure available in defined benefit plans,” and particularly on “the advantages to an employee of being able to elect a QLAC structure under a defined benefit plan, instead of electing a lump sum distribution from a defined benefit plan and rolling it over to a defined contribution plan or to an IRA in order to purchase a QLAC.” Hence, there may be more to come on the QLAC story. The Treasury, apparently, is still worried, but maybe not quite as much as before. ◀

END NOTES

- ¹ See also Christian DesRochers, “Proposed Regulation to Accommodate Longevity Annuities in Retirement Plans,” *Taxing Times*, Vol. 8, Issue 2, May 2012.

ACLI UPDATE

By Pete Bautz and Mandana Parsazad



In 2012, the District of Columbia (D.C.) City Council passed the Health Benefit Exchange Authority Establishment Act (Establishment Act). This law created D.C.'s Health Benefit Exchange Authority (Exchange) and also provided authority to the Exchange to assess, through rulemaking, a fee from carriers of qualified health plans in order to fund its operations once federal funding expires in October 2014.

In February 2014, the Executive Board of the Exchange published its Assessment Rule. The Rule allows for imposition of the assessment on all "health" carriers including those that sell only excepted benefits products, such as long-term care and disability plans, which by law, are not qualified health plans and cannot be offered on the Exchange. In May 2014, the D.C. Council enacted emergency legislation that would amend the Establishment Act to directly impose fees on excepted benefit carriers.

On July 3, 2014, ACLI filed a Complaint for Declaratory Judgment and Motion for Injunctive Relief in the United States District Court for the District of Columbia against the Exchange. The lawsuit, which was assigned to the Honorable Judge Beryl Howell, contended that legislation recently enacted by the DC Council assessing insurers that cannot or do not sell their products on the Exchange violates the Patient Protection and Affordable Care Act (ACA) and the U.S. Constitution. ACLI noted its support for the operation of state exchanges, and an appreciation of the need for revenue sources to fund them. However, both federal and state law clearly dictate that exchange authorities must look solely to carriers of qualified health plans that are subject to the authority's jurisdiction for funding. ACLI argued that

- Under the ACA, only qualified health plans can be offered through the Exchange. Excepted benefit plans, such as disability, long-term care, and accident coverage, are not qualified health plans. Excepted benefit issuers are therefore prohibited from offering their products on the Exchange.
- Issuers of excepted benefit plans cannot benefit from the

Exchange's insurance market and will have no opportunity to recoup assessment costs through the Exchange.

- Because excepted benefit issuers do not benefit from operation of the Exchange, these issuers should not be required to finance the Exchange solely to generate revenue for a separate segment of the insurance industry.
- The ACA authorizes state health insurance exchanges to charge participating health insurance issuers assessments or user fees in order to finance post-2014 exchange operations.
- ACA regulations provide that state exchange rules cannot conflict with ACA provisions.
- Because the D.C. Assessment Rule levies assessments on excepted benefit issuers that cannot participate in the Exchange, it conflicts with the ACA and must be amended in order to align with federal law.
- The Assessment Rule can be amended to comply by simply limiting assessments to issuers of "qualified health plans" or "health benefit plans," as these terms are defined in the D.C. Code.

The ACLI lawsuit sought to enjoin the Exchange from issuing assessments on non-participating insurers. In response, the District filed a motion to dismiss the ACLI lawsuit. A hearing on ACLI's Complaint was held on July 29, during which Judge Howell announced her intention to decide on the ACLI and District motions simultaneously.

In mid-August, the Exchange issued assessment notices to all insurance carriers authorized to sell health, long-term care, disability income and supplemental benefit insurance in the District, regardless of whether the carriers were offering their products on the Exchange. The Notice of Assessment was addressed to the company's Corporate Treasurer/Tax Officer; assessments were equivalent to one percent of the company's 2013 gross health insurance receipts. Generally, the assessment notices provided for a mid-September 2014 deadline for filing an administrative appeal. The appeal process provides very limited grounds for challenging an assessment. The

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deadline for payment of the assessments in the notices was set for Sept. 30, 2014.

ACLI notified the District Court in a supplemental declaration filing that assessment notices were issued to companies. It should be noted that, at the time the assessments were issued, the Exchange had no process for refunding assessment payments, even if the ACLI litigation effort was ultimately successful. We had anticipated a decision from the court sometime prior to the date the assessments are due, because Judge Howell had indicated her intention to decide on ACLI's motion for preliminary injunction and the District's motion to dismiss together.

On November 13, Judge Howell dismissed ACLI's complaint against the District of Columbia. Despite the ruling, ACLI maintains that D.C.'s assessment on excepted benefit products and other products that are not sold on the Exchange to fund its health exchange violates the ACA and is unconsti-

tutional. On December 12, ACLI filed a notice of appeal to a District Court's decision dismissing ACLI's original complaint against the District of Columbia. ◀

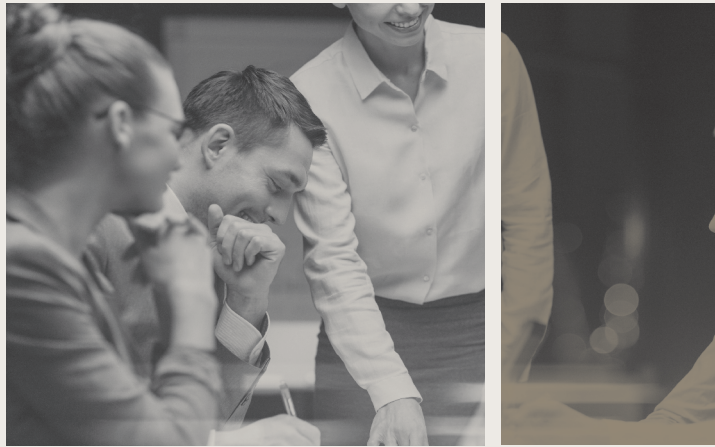


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DOES THE TAX LAW REQUIRE THAT STATUTORY RESERVES BE BACKED BY ASSETS?

By *Brion D. Graber*

On Aug. 29, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling 201435011 (May 16, 2014), which addresses the computation of “losses incurred” under Section 832(b)(5) and the statutory cap on discounted unpaid losses under Section 846(a)(3).¹ Although the letter ruling involves a nonlife insurance company in rehabilitation, life insurers may find it useful in determining the statutory reserve cap under Section 807(d). In particular, the letter ruling supports the position that the computation of an insurer’s statutory reserve cap does not depend on the nature or quality of assets, or even whether there are assets, supporting reserves accepted by a life insurer’s regulator on the annual statement.

Stated Facts

The taxpayer in the letter ruling wrote insurance policies with respect to a particular business and ultimately incurred significant losses on certain of those policies. After those losses were incurred, the taxpayer voluntarily stopped writing new policies. The taxpayer’s regulator then issued an order suspending further payment on any policy claims and prohibiting the taxpayer from writing any new policies.

The taxpayer’s parent commenced a bankruptcy proceeding. The bankruptcy court ordered the appointment of a rehabilitator for the taxpayer and began a court-supervised rehabilitation proceeding. A rehabilitation plan was ultimately approved that provided that when a policyholder makes a valid claim under a policy, the claim will be divided into a portion that will be paid currently and a portion that may be paid in the future. More specifically, the taxpayer will pay promptly a portion of the claim in cash based on the cash payment percentage in effect at the time; the remaining portion of the claim will be deferred, and may become payable in the future depending on the taxpayer’s

financial performance and condition. In accordance with the rehabilitation plan and the regulator’s guidelines under that plan, the taxpayer will adjust its statutory accounting treatment of the restructured policies to establish and maintain a “minimum surplus amount” that will be reflected on its annual statement. The letter ruling does not describe the reason for the maintenance of this amount, but presumably the taxpayer lacked sufficient assets to cover all of its losses and the regulator wanted to ensure it maintained a certain level of surplus. In any case, the reporting of the minimum surplus amount ultimately decreases the amount of undiscounted unpaid losses reported on the taxpayer’s annual statement.

Relevant Law

Taxable income for nonlife insurance companies includes “the combined gross amount earned during the taxable year, from investment income and from underwriting income ... computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners.”² Underwriting income equals the premiums earned on insurance contracts during the taxable year less losses and expenses incurred.³ Losses incurred include the increase or decrease during the year in discounted unpaid losses (as defined in Section 846),⁴ which are determined by discounting the unpaid losses shown on the insurer’s annual statement.⁵ In no event, however, may the amount of discounted unpaid losses exceed the amount of unpaid losses included on the annual statement (i.e., the statutory cap on discounted unpaid losses).⁶

IRS Conclusions

In Private Letter Ruling 201435011, the IRS ruled without much discussion that the taxpayer can take into account in computing “losses incurred” under Section 832(b)(5), both the portion of the claim the taxpayer will pay promptly in cash and the deferred portion of the claim that is not currently payable, but may become payable in the future.⁷ Citing Treas. Reg. § 1.832-4, the IRS stated that (1) the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them, and (2) the losses must

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be stated in amounts that represent a fair and reasonable estimate, based on the facts and the taxpayer's experience, of the amount the taxpayer will owe to the policyholder.

Also with little discussion, the IRS ruled that the statutory cap on the taxpayer's discounted unpaid losses under Section 846(a)(3) shall be determined without any adjustment related to unpaid losses as a result of the guidelines the taxpayer's regulator issued under the rehabilitation plan. Those guidelines required the taxpayer to establish and maintain a minimum surplus amount, which ultimately decreases the amount of undiscounted unpaid losses reported on the annual statement.

Relevance for Life Insurers

Our law firm has sometimes been asked whether the statutory reserve cap under Section 807(d) is determined without regard to the nature of the assets the taxpayer holds, or even whether the taxpayer holds assets, to support its reserves as reported on the annual statement. Although Private Letter Ruling 201435011 involves a nonlife insurer under a rehabilitation plan, not a life insurer, it nevertheless appears to offer support for that position.

The Section 846 statutory cap is generally modeled on the Section 807(d) statutory cap. Section 846(a)(3) provides that "[i]n no event shall the amount of discounted unpaid losses with respect to any line of business attributable to any accident year exceed the aggregate amount of unpaid losses with respect to such line of business for such accident year included on the annual statement filed by the taxpayer for the year ending with or within the taxable year." Section 807(d)(1) similarly provides that "[i]n no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves." Section 807(d)(6) provides that, for this purpose, statutory reserves "means the aggregate amount set forth in the annual statement with respect to items described in section 807(c)."

In Private Letter Ruling 201435011, the IRS concluded that the taxpayer should compute its losses incurred and the statutory cap on discounted unpaid losses without regard to the adjustment for the minimum surplus amount the taxpayer was required to report on its annual statement, even though reporting of that amount decreases the amount of undiscounted unpaid losses reported on the annual statement. If it is appropriate to ignore the minimum surplus amount in that context, it follows that the existence, nature, or quality of assets supporting a life insurer's reserves should not be a factor in the determination of the insurer's Section 807(d) statutory reserve cap. ◀

END NOTES

- ¹ Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.
- ² Section 832(a), (b)(1)(A).
- ³ Section 832(b)(3).
- ⁴ Section 832(b)(5).
- ⁵ Section 846(a), (b)(1).
- ⁶ Section 846(a)(3). This cap could come into play, for example, when reserves that are already discounted on the annual statement are grossed up before being discounted for tax purposes. See Section 846(b)(2).
- ⁷ In an earlier letter ruling involving a different taxpayer with similarly restructured policies, the IRS reached the same conclusion, and included the same discussion, regarding the computation of "losses incurred" under Section 832(b)(5). PLR 201429007 (March 12, 2014).

TO CLONE OR NOT TO CLONE: THE IRS ANSWERS AN INVESTOR CONTROL QUESTION

By John T. Adney and Bryan W. Keene

Since the late 1970s, the Internal Revenue Service (IRS) has repeatedly said that excessive control over the separate account investments underlying a variable annuity or life insurance contract by the owner of that contract will forfeit the customary income tax treatment of the contract's owner. Instead of benefitting from non-taxation of the contract's cash value buildup—the "inside buildup"—prior to any distributions from the contract, the owner will be taxed on the earnings of the investments underlying the contract where that owner is found to possess "investor control" over those investments.¹ Congress waded into this fray in 1984, providing the IRS with a statutory tool—specifically, IRC section 817(h)—to enforce its 1981 ruling that a variable contract based on a single mutual fund available for purchase by the public apart from the contract was a prima facie case of investor control.²

While the "doctrine" of investor control is thus embedded in the tax landscape for variable contracts, there is less clarity on exactly what constitutes impermissible control by a contract owner. The IRS has said that an owner may allocate and reallocate cash values among a limited number of investment options available under a contract without invoking the doctrine and its unfortunate consequences, provided that none of those options represent funds available for public purchase. Not

infrequently, the line between permissible and impermissible control is shrouded in something of a legal fog, a fog that conceals a cliff off of which no one is anxious to fall. Not surprisingly, taxpayers seeking to remain atop the cliff periodically ask the IRS for guidance, via the private letter ruling process, on whether their contract designs violate the investor control doctrine.

A recent instance of a private letter ruling on the investor control doctrine, specifically focusing on public availability of a variable contract's underlying mutual funds, is PLR 201436005, issued by the IRS on May 29, 2014, and released to the public the following September 5th. In brief, the ruling dealt with the application of the doctrine to a new insurance-dedicated mutual fund (Insurance Fund) which the requesting taxpayer essentially characterized as a "clone" of an existing publicly-available mutual fund (Retail Fund), subject to a few caveats. In the ruling, the IRS concluded that the formation and operation of the Insurance Fund and its similarity and relation to the Retail Fund would not cause the variable contract holders to be treated as owning shares of the Insurance Fund for federal income tax purposes under the investor control doctrine.

The facts. The private letter ruling was requested by the investment adviser (Adviser) to a trust registered as an open-end investment company under the Investment Company Act of 1940 (the Trust). According to the ruling's statement of facts, the Trust currently has nine series, each of which is treated as a separate regulated investment company (RIC) for tax purposes. One of the series is the Retail Fund, which is available for investment by the general public directly rather than solely through the purchase of an insurance or annuity contract.

The ruling letter recounts that the Adviser is planning to establish the Insurance Fund as the tenth series of the Trust (and a separate RIC), but to make it available for investment only by life insurance company separate accounts in support of life insurance and annuity variable contracts or by other investors permitted under the "look-through" rules of the section 817(h) regulations.⁴ Owners of variable contracts would thus be able to allocate cash values under their contracts to the Insurance Fund as an investment option.

The Retail Fund and the Insurance Fund would have identical investment strategies—the ruling letter used the term "identical"—and would be managed by the same subadviser under an agreement with the Adviser (Subadviser). Investment decisions for both funds would be made by the Subadviser at the same time, and trades would be executed for both funds simul-

taneously. That said, the ruling observes that the investment returns of the two funds "will potentially deviate" in certain respects. One reason for this is a potential lower concentration in Treasury securities by the Insurance Fund due to the section 817(h) diversification requirements applicable to the Insurance Fund; the Insurance Fund would be used to support annuity contracts as well as life insurance contracts, and so would be limited in the proportion of Treasury securities it could hold. Other possible differences between the two funds include variations in "current or expected cash flows," the sizes of the two funds, "other operational or financial circumstances," and the fees imposed under certain share classes. With respect to fees, the ruling observes that the Retail Fund and the Insurance Fund would each offer multiple share classes that may differ based on "differing levels of distribution and, or, shareholder service fees." The ruling goes on to note, however, that the investment advisory fee would be the same for both funds, and that at least one share class of the two funds would have identical expense structures.

The Adviser made various representations consistently with those found in prior IRS rulings on the investor control doctrine. According to the representations recorded in the ruling letter, the Adviser or Subadviser would make all investment decisions for the Insurance Fund, and no policyholder would be able to direct the Insurance Fund to invest in any particular asset or recommend any particular investment or investment strategy. In this regard, policyholders would not be able to communicate, directly or indirectly, with the Adviser or Subadviser regarding the selection, quality, or rate of return on any specific investment or group of investments held by the Insurance Fund. Further, there would be no agreement or plan between the Adviser or Subadviser and any policyholder regarding a particular investment of the Insurance Fund, or regarding the availability of the Insurance Fund as an investment option under a variable contract. Also, no policyholder would have any current knowledge of the Insurance Fund's specific assets (although such information would be available on a delayed basis, in accordance with SEC rules).

The IRS's holding. Lest anyone think that the investor control doctrine is no longer alive—some have argued that the enactment of section 817(h), or even section 7702, overrode the doctrine—the ruling letter recounts an array of published guidance on the doctrine. It then observes, after noting that a determination under the investor control doctrine "depends on all the relevant facts and circumstances," that:

In the instant case, the Variable Contract holders do

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not have any control over Insurance Fund's investments. The investment decisions of Insurance Fund are made by Insurance Fund's Adviser and Subadviser in their sole and absolute discretion and are subject to change without notice to or approval by the Variable Contract holders. The Variable Contract holders in this case do not have any more control over the assets held under their contract than was the case in Rev. Rul. 82-54 or Rev. Rul. 2003-91. Insurance Fund is not an indirect means of allowing a Variable Contract holder to invest in a publically-available fund.

Based on the foregoing, the ruling concludes that the formation and operation of the Insurance Fund, and its establishment as a separate series within the same Trust as Retail Fund, would not cause the policyholders to be treated as the owners of the Insurance Fund shares for federal income tax purposes.

Concluding observations. PLR 201436005 is the latest in a series of private letter rulings evidencing a trend towards IRS acceptance of common industry practices regarding the use of so-called clone funds in support of variable insurance products. The ruling is very similar to PLR 201417007 (Dec. 19, 2013). The potential investor control question in the context of an insurance-dedicated fund that has a publicly-available clone (or vice versa) is whether the similar (or perhaps identical) holdings of the two funds will cause the insurance-dedicated fund to be treated as publicly available. Although the legislative history of section 817(h) suggests that the answer should be no,⁵ the question has persisted, in part due to the uncertainty involved in applying the investor control doctrine (the fog noted above) and in part because of the disconnect between that doctrine and section 817(h). Perhaps significantly, as the basis for its conclusion, the ruling defaults to the perceived result of the IRS's prior rulings—"The Variable Contract holders in this case do not have any more control over the assets held under their contract than was the case in Rev. Rul. 82-54 or Rev. Rul. 2003-91"—and then makes a substance-over form point: "Insurance Fund is not an indirect means of allowing a Variable Contract holder to invest in a publically-available fund." Clearly, the IRS has not backed away from its fundamental ruling position on the investor control doctrine.

This latest ruling does suggest a growing acceptance by the IRS that no investor control problem will arise in clone fund situations involving retail products, as long as there is at least some possibility that differences will exist between the insurance-dedicated fund and the publicly available retail fund. Those differences may even be relatively minor, and perhaps

may never materialize at all. While this may be a sign that the fog is lifting a little, it is important to remember that the ruling concerns retail mutual funds, that differences between the insurance-related fund and the public fund could emerge despite their common objectives and fees and management, and that the application of the investor control doctrine "depends on all the relevant facts and circumstances." ◀

END NOTES

- ¹ See Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 82-54, 1982-1 C.B. 11; Rev. Rul. 81-225, 1981-2 C.B. 13; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12; see also *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984), *cert. denied*, 473 U.S. 905 (1985).
- ² IRC section 817(h) authorizes regulations requiring "adequate" diversification of variable contract separate account investments. The regulations issued under that provision, found in Treas. Reg. § 1.817-5, effectively preclude basing a variable contract on a single, publicly available mutual fund. The ruling mentioned is Rev. Rul. 81-225, cited in note 1 *supra*.
- ³ See Rev. Rul. 2003-91, *supra* note 1.
- ⁴ Treas. Reg. § 1.817-5(f)(3).
- ⁵ See H.R. Rep. No. 98-861, at 1055 (1984) (Conf. Rep.) ("The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available.")

SUBCHAPTER L: CAN YOU BELIEVE IT? STATUTORY RESERVES DO NOT ALWAYS HAVE TO BE SET FORTH IN THE ANNUAL STATEMENT

By Peter H. Winslow

Deductible federally prescribed reserves are capped by statutory reserves. To qualify as statutory reserves for this purpose, I.R.C. § 807(d)(6) provides that the reserves must be "set forth" in the annual statement. Is there ever an instance where tax reserves should not be capped even though they exceed statutory reserves that are reported in the annual statement? Yes, when statutory reserves are weakened.

A simple example illustrates how reserve weakening results in this tax reserve anomaly. Suppose a life insurer issues contracts that include a disability waiver-of-premium benefit

for an additional charge. Tax reserves for this type of benefit are equal to the reserves taken into account on the annual statement because they are held for qualified supplemental benefits under I.R.C. § 807(e)(3). Now suppose the company changes its basis of computing its statutory reserves for this benefit and the result is lower statutory (and therefore tax) reserves. In such case I.R.C. § 807(f) comes into play. I.R.C. § 807(f) defers until the succeeding taxable year the tax recognition of the decreased reserves resulting from the reserve weakening for contracts issued before the taxable year. For those contracts, tax reserves are computed on the old method for the year of change, and reserves computed on the new method are used for the years thereafter. The difference between the closing reserves computed on the old basis and the closing reserves computed on the new basis for the year of change is spread over ten years beginning in the year following the year the change in basis of computing reserves occurs. Going back to the qualified supplemental benefits example, the effect of I.R.C. § 807(f) is that the year-of-change tax reserves are computed for previously-issued contracts as if no change in statutory reserves occurred. But wait. Should we cap tax reserves for the year of change by the lower amount of statutory reserves actually “set forth” for that year in the annual statement? The answer is “no.”

The technical statutory language under current law that leads to this result is found in I.R.C. § 807(f) itself. The requirement to compute reserves using the “old basis” for the year of change refers to the entire reserve “item” described in I.R.C. § 807(c), which by its terms includes application of the statutory reserves cap.

I.R.C. § 807(f) is carried over almost word-for-word (with minor conforming amendments) from former I.R.C. § 810(d) in effect before the Tax Reform Act of 1984. Also, in general, except where an election was made with respect to preliminary term reserves, tax reserves under pre-1984 Act law were equal to reserves set forth in the annual statement.¹ Therefore, the concepts of both statutory reserves and of reserve strengthening or weakening of statutory (and tax) reserves under current law are generally the same as under pre-1984 Act law. The legislative history of the 1984 Act states that “where provisions of prior law are incorporated in the [1984] Act, the Congress expects that, in the absence of contrary guidance in the committee reports and conference agreement, the regulations, rulings, and case law under prior law will serve as interpretative guides to the new provisions.”² This legislative history confirms that we should look for guidance as to how reserve weakening works under current law by examining how former I.R.C. § 810(d)

operated when statutory (and tax) reserves were weakened.

There is no doubt that under former I.R.C. § 810(d) deductible tax reserves for contracts issued in prior years were not reduced by the reserve weakening in the year of change.³ This was so even though life insurance reserves were required to be “set aside” and “required by law” under former I.R.C. § 801(b), as well as required to be “held” under Treas. Reg. § 1.801-4(d). The same result should apply to reserve weakening under current law where statutory reserves similarly are required to be “set forth.” That is, the statutory reserve cap should not come into play to limit tax reserves required to be computed on the old basis in the year of change. Thus, as under prior law, the reserve weakening rules of I.R.C. § 807(f) should trump the “set forth” requirement for statutory reserves in I.R.C. § 807(d)(6).

The same analysis also should apply in the more complicated scenario when federally prescribed reserves computed under I.R.C. § 807(d) and statutory reserves are both weakened. Just as in the case of statutory reserves for qualified supplemental benefits subject to the statutory reserves cap, the requirement of I.R.C. § 807(f) to remain on the old tax reserve method for the year of change should override the “set forth” requirement in the definition of statutory reserves in I.R.C. § 807(d)(6). So, in the case of reserve weakening, statutory reserves need not be “set forth” statutory reserves in the year of change. *Can you believe it?* ◀

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END NOTES

- ¹ Former I.R.C. § 810; *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).
- ² Jt. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 581 (Comm. Print 1984).
- ³ See examples in Treas. Reg. § 1.810-3(b) which provide that reserves at the end of the year of change for contracts issued before the year of change are determined on the “old” basis.

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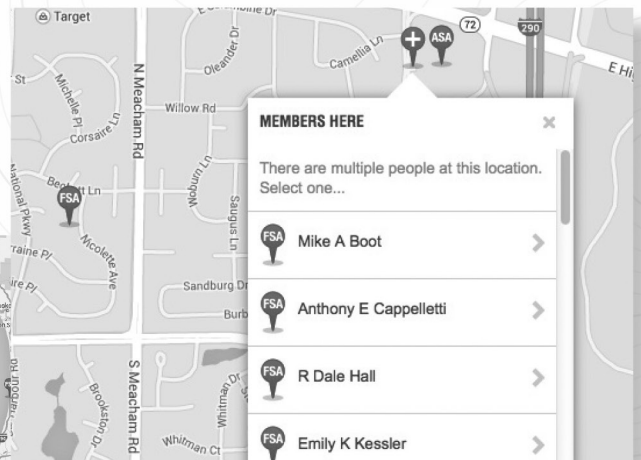
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