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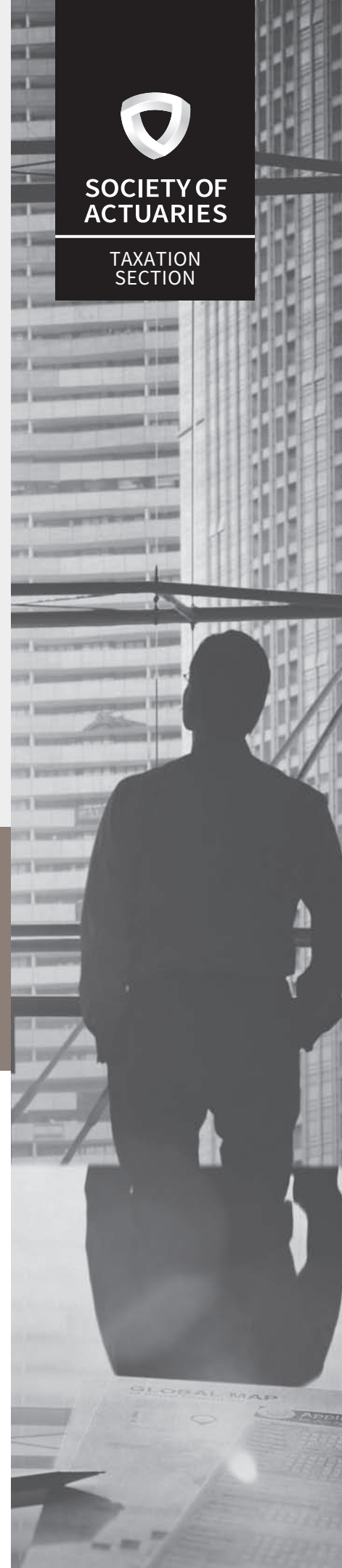
# Taxing Times

VOLUME 12, ISSUE 3 • OCTOBER 2016

## Product Tax Implications of the Adoption of the 2017 CSO Tables

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# From The Chair A Year in Review

By Jeffrey Stabach

This issue of *TAXING TIMES* marks the third installment of 2016. For those actuaries that are counting, that makes this my last column as section chair. Before moving on and passing the reins to the next chair and council members, I'd like to look back at some of the many highlights of the Taxation Section from this past year:

- **TAXING TIMES:** This newsletter continues to provide timely and informative information on life insurance taxation. It is continually recognized as the “crowning jewel” of the Taxation Section. The highlights from this year include articles on recent developments in principle-based reserves, analysis on private letter rulings (PLRs), and dialogues regarding the taxation of life insurance companies and products.
- **Webinar:** Our section sponsored the “Federal Income Tax Issues Every Company Must Consider Under Life PBR” webinar this past June. As its title may suggest, the webinar explored issues that may arise from a Federal income tax perspective that companies may have with the adoption of life PBR. See the article on page 32 for additional information on this webinar.
- **Meeting Sessions:** The Taxation Section sponsored multiple sessions and a breakfast at the Life and Annuity Symposium, the Valuation Actuary Symposium, and the 2016 SOA Annual Meeting & Exhibit. The sessions provided updates and education on company tax, product tax, and recent developments affecting life insurers.



- **Product Tax Seminar:** Even though I'm writing this article before the seminar actually occurs, I'm sure the seminar will be a productive and educational experience for those that attend. I've been fortunate to have attended the past three Product Tax Seminars and find that I have increased my product tax knowledge and understanding each time I attend.

I'd like to thank the other council members and Friends of the Council for their hard work over the past year, especially our affiliate members. I greatly appreciate your contributions to serve as authors, editors, and speakers at the various tax section sponsored events. Our section would not be the same without you.

It has truly been an honor to be on the council and to serve as section chair for the past year. I look forward to staying actively involved with the section in the future. ■

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# Product Tax Implications of the Adoption of the 2017 CSO Tables

By John T. Adney, Craig Springfield and Brian King

**T**he National Association of Insurance Commissioners (NAIC) has adopted a fundamental change in approach for establishing valuation standards for life insurance products that will significantly alter the process for recognition of new mortality tables, due in large part to the advent of principle-based reserving. This change in approach was initiated by the NAIC's 2009 adoption of revisions to the Standard Valuation Law,<sup>1</sup> which was then followed in December 2012 by its adoption of the Valuation Manual, a technical how-to-guide with specifics that will allow actuaries and senior management of companies to implement principle-based reserving. After a lengthy state approval process, requiring adoption by a supermajority of NAIC jurisdictions (*i.e.*, at least 42 jurisdictions, with eligible jurisdictions including the states, D.C., and certain territories) representing 75 percent of direct written premium, the Valuation Manual is now scheduled to become operative on Jan. 1, 2017.

[T]he most important and pressing need is for IRS guidance that provides a safe harbor for use of the 2017 CSO Tables...

The Valuation Manual changes the process used by the NAIC and states for adopting new mortality tables. In the past, new mortality tables were recognized by regulation. For example, for the 2001 Commissioners' Standard Ordinary (CSO) Mortality Tables (the 2001 CSO Tables), the NAIC adopted a regulation in 2002 titled *Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation* (the 2001 CSO Model Regulation),<sup>2</sup> which provided both a permitted date (based on state adoption) and a required date (Jan. 1, 2009) for its use. The 2001 CSO Model Regulation required individual state approval, and thus there was a lengthy approval process before a majority of the states had adopted the 2001 CSO Tables. (As discussed in more detail below, to be a prevailing table for tax purposes, at least 26 states must permit use of the table.)



Under the new approach, new mortality tables will be adopted by the NAIC via amendments to the Valuation Manual without the need for state legislation or a separate state regulatory process, significantly shortening the duration of the process for introducing new mortality tables.<sup>3</sup> In particular, the Valuation Manual as presently adopted generally contemplates that such amendments would automatically take effect, and thus a change in mortality tables would be implemented based on the effective date of the Valuation Manual amendment without the need of any state action. The 2017 Commissioners' Standard Ordinary Mortality Tables (the 2017 CSO Tables) are the first mortality tables following the new adoption process, under which the NAIC adopted amendments to the Valuation Manual in 2015 recognizing the 2017 CSO Tables for both valuation and nonforfeiture purposes with a Jan. 1, 2017 permitted use date and a Jan. 1, 2020 mandatory use date.<sup>4</sup>

This article is part 1 of a two part series addressing product tax implications of the adoption of the 2017 CSO Tables. Part 1 describes the mortality requirements of sections 7702 and 7702A of the Internal Revenue Code (IRC), which define the terms "life insurance contract" and "modified endowment contract" for federal tax purposes, respectively, and guidance from the Internal Revenue Service (IRS) on this subject. It then highlights the need for new IRS guidance relating to the 2017 CSO Tables. Finally, part 1 concludes with a discussion of the impact of the 2017 CSO Tables on the funding limitations under sections 7702 and 7702A.

Part 2 will discuss guidance issued by the IRS on the 2017 CSO Tables, which is expected later this year or in early 2017.

## MORTALITY CHARGE REQUIREMENTS UNDER IRC SECTIONS 7702 AND 7702A

Section 7702, which was enacted in 1984 by the Deficit Reduction Act of 1984 (DEFRA),<sup>5</sup> imposes funding limitations on life insurance contracts. These limitations serve to restrict the allowable premiums and/or cash values for a qualifying life insurance contract. At the heart of the limitations are actuarial limits that are based on a mortality assumption with respect to the underlying insured. To address a problem of manipulation that arose after DEFRA, in 1988 Congress enacted the reasonable mortality charge rule through an amendment to section 7702(c)(3)(B)(i), which placed limitations on the allowable mortality that can be taken into account in calculating guideline premiums for contracts subject to the guideline premium test and net single premiums for contracts subject to the cash value accumulation test.<sup>6</sup>

The reasonable mortality charge rule requires the use of “reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners’ standard tables (as defined in section 807(d)(5)) as of the time the contract is issued.” The change in mortality requirements from a prescriptive basis to one based on a reasonableness standard added to the complexity that companies face in the design, development, and ongoing administration of life insurance contracts with the section 7702 requirements. The discussion that follows provides additional detail and commentary around the reasonable mortality standards currently applicable for purposes of sections 7702 and 7702A.

### The Permanent Mortality Rule

The reasonable mortality requirements can be viewed as having both a *permanent rule* and an *interim rule*, the satisfaction of either of which is sufficient. The *permanent rule* refers to the specific statutory language in section 7702(c)(3)(B)(i), as set forth above. While requiring that mortality charges used in section 7702 (and by cross-reference under section 7702A) be “reasonable,” the statute does not provide any guidance on how reasonableness should be determined, except in two respects. First, the statute delegates authority to the Department of the Treasury to prescribe regulations to address the meaning of “reasonable mortality charges.” Second, the permanent rule clarifies that reasonable mortality charges cannot exceed the rates in the prevailing commissioners’ standard table at the time a contract is issued unless authorized by regulations.<sup>7</sup>

Section 5011(c)(1) of TAMRA directed the Secretary of the Treasury to issue regulations under section 7702(c)(3)(B)(i) by Jan. 1, 1990, setting forth standards for determining the reasonableness of assumed mortality charges. In response, proposed regulations were issued in 1991, but to date have not been finalized. As a consequence, the permanent mortality rule is am-

## THE PREVAILING COMMISSIONERS STANDARD TABLE

The concept of the prevailing table as a limitation on the reasonableness of mortality was borrowed from the rules in life insurance company taxation governing the deductibility of life insurance reserves. Under section 807(d)(5), which places a limitation on the mortality that may be assumed in the computation of deductible life insurance reserves, the prevailing commissioners’ standard table generally is defined as the most recent commissioners’ standard table prescribed by the NAIC which is permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued. At the time the reasonable mortality standards were added to section 7702, 1980 CSO was the prevailing commissioners’ standard table. Therefore, under the *permanent rule*, 100 percent of the sex-distinct 1980 CSO Tables generally provided an upper bound on reasonable mortality for contracts issued at that time.

The 2001 CSO Tables replaced the 1980 CSO Tables as the most recent standard table prescribed by the NAIC once these new tables were adopted by 26 states in July 2004, and the effective date for use of the new tables was dictated by the section 807(d)(5)(B) three year transition rule. More recently, in 2015, the NAIC adopted amendments to the Valuation Manual that would permit the use of new mortality tables—*i.e.*, the 2017 CSO Tables—beginning Jan. 1, 2017. With the necessary state legislation or regulations already in place to make the Valuation Manual operative on Jan. 1, 2017, the 2017 CSO Tables will be a new prevailing commissioners’ standard table on Jan. 1, 2017.

To allow companies to transition to a new prevailing table, section 807(d)(5)(B) includes a rule that generally allows for the continued use of the old prevailing table for a three year period following the effective date of the new prevailing table, *i.e.*, with permitted use of either the 2001 CSO Tables or 2017 CSO Tables for contracts issued from Jan. 1, 2017 through Dec. 31, 2019, and with the 2017 CSO Tables being mandatory thereafter.

biguous with respect to the meaning of “reasonable mortality charges” but does limit assumed mortality charges to 100 percent of the prevailing commissioners’ standard tables in effect on the issue date of the contract. Thus, under the permanent mortality rule, reasonable mortality will be limited to the 2017 CSO Tables for contracts issued after the three year transition period provided by section 807(d)(5)(B), *i.e.*, after Dec. 31, 2019.

### The Interim Mortality Rule

In the 1988 legislation, Congress also provided an interim rule for contracts issued on or after Oct. 21, 1988, but before the effective date of temporary or final regulations on the reasonable mortality standards. The interim rule states that mortality charges which do not differ materially from the charges actually expected to be imposed by the company (taking into account any relevant characteristics of the insured of which the company is aware) shall be treated as meeting the requirements of section 7702(c)(3)(B)(i). As regulations have yet to be issued, the interim rule remains in effect. Thus, a contract can satisfy the reasonable mortality requirements of section 7702 either by satisfying the permanent rule or the interim rule.

Similar to the permanent mortality charge rule, the interim mortality rule presents an imprecise standard that is dependent on the interpretation of a legal phrase—in particular, whether charges assumed “differ materially” from those actually expected to be imposed. Thus, for whichever of these rules is used, it is necessary to apply an imprecise legal standard to define the mortality assumption that will be used by rules-based tests and administration systems that rely on actuarial values for measuring compliance. The life insurance industry has expressed its concerns to the IRS over the ambiguity in both the permanent and interim rules. Given the long-term nature of life insurance contracts and their associated guarantees, concern has especially focused on any possible rules or interpretations that could require use of actuarial limitations based on expected current mortality charges. In light of these considerations, and also in view of the consequences of noncompliance, the industry has sought guidance in the form of safe harbors (discussed below) that generally allow the use of 100 percent of the prevailing tables for contracts covering standard risks. Use of these tables was believed to be necessary, for example, to provide some certainty that traditional contracts tested under the cash value accumulation test would satisfy the requirements of both section 7702 and the Standard Nonforfeiture Law for life insurance contracts.

## IRS GUIDANCE ON THE REASONABLE MORTALITY REQUIREMENT

### Pre-2001 CSO Era Guidance

In the aftermath of the 1988 enactment of the reasonable mortality charge requirements by TAMRA, the IRS issued Notice 88-128,<sup>8</sup> which previewed anticipated future rules and responded to the industry’s request for safe harbor guidance; this notice was then followed several years later with the issuance of proposed regulations by the IRS.<sup>9</sup> As one safe harbor, Notice 88-128 provided that “a mortality charge meets the requirements of section 7702(c)(3)(B)(i) if such mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 1980 CSO tables.” The notice does not expressly discuss the

smoker-distinct versions of the tables, although seemingly they are encompassed by this safe harbor.<sup>10</sup> The notice does speak, however, to the unisex version of the tables, providing that, “to the extent that a state requires ... [the use of ] unisex tables, thereby imposing, for female insureds, mortality charges that exceed the [sex-distinct] 1980 CSO tables, ... [the increased mortality charges] may be taken into account with respect to contracts to which that unisex requirement applies.” This left voluntary use of the unisex versions of the table unaddressed, although seemingly the safe harbor should apply at least where federal law requires use of unisex tables.<sup>11</sup>

As noted, in 1991 the IRS issued proposed regulations to define reasonable mortality charges for use in computations under sections 7702 and 7702A. The proposed regulations were controversial, have never been finalized, and thus are not in effect. As a general rule, the proposed regulations defined reasonable mortality charges as “those amounts that an insurance company actually expects to impose as consideration for assuming the risk of the insured’s death (regardless of the designation used for those charges), taking into account any relevant characteristics of the insured of which the company is aware.”<sup>12</sup> This standard is similar to that of the reasonable expense charge rule of section 7702(c)(3)(B)(ii), despite the substantially different statutory rules prescribed by the two statutes. While Congress adopted a standard for expenses based on expectation of payment, mortality charges are inherently different in that the prevailing table establishes a fixed and ascertainable benchmark. This characteristic of the prevailing table, and other industry arguments demonstrating the compelling need for a conservative assumption in light of the long-term nature of life insurance contracts, was given short shrift by the IRS in its establishment of this general rule, although this harsh rule was ameliorated to a degree by the proposed regulations’ inclusion of more generous safe harbors. One such safe harbor generally allowed for use of the 1980 CSO Tables, and smoker-distinct and gender-blended rates also were authorized if certain conditions are met, including consistent use of tables for a plan of insurance.

### 2001 CSO Era Guidance

The 2001 CSO Tables were adopted by the NAIC in December 2002 and became the prevailing table in July 2004 after adoption by 26 states. Thus, at this time the 2001 CSO Tables replaced the 1980 CSO Table as the most recent standard ordinary mortality table prescribed by the NAIC. With the adoption of the 2001 CSO Tables came the need for IRS guidance on several fronts. Most significantly, there was need for an update to the safe harbors contained in Notice 88-128, since the industry again wished to avoid reliance on the imprecise standards of the permanent and interim mortality charge rules. There was also interest in guidance on the interaction between the 2001 CSO Tables’ terminal age of 121 and the computational rule of sec-



tion 7702(e)(1)(B), which requires the maturity date assumption for purposes of section 7702 to be no later than the insured's age 100. Whereas Notice 88-128 had been issued soon after TAM-RA's enactment in reflection of the effective date of the statute's reasonable mortality charge rule, the IRS engaged in a lengthier process that involved seeking industry comments in providing guidance for the transition to the 2001 CSO Tables.

The first step in this process was the IRS's issuance of Notice 2004-61,<sup>13</sup> which provided a set of safe harbor rules similar to those contained in Notice 88-128 and were intended to enable an orderly transition to the new 2001 CSO Tables. The safe harbors under this notice addressed both 1980 CSO contracts and 2001 CSO contracts, permitting each set of tables to be used under section 7702 and 7702A in specified time periods. Then, reacting to industry comments concerning some uncertainties raised by this notice, the IRS issued Notice 2006-95,<sup>14</sup> which reiterated the prior notice's safe harbors but made some helpful clarifications.<sup>15</sup> According to its terms, Notice 2006-95 "supplements" Notice 88-128 and "modifies and supersedes" Notice 2004-61.

Notice 2006-95, like its 2004 predecessor, provides safe harbors for contracts based on both the 1980 and 2001 CSO Tables. These safe harbors provide that a mortality charge will satisfy the requirements of section 7702(c)(3)(B)(i) so long as the conditions of the applicable safe harbor are satisfied. The notice's 1980 CSO safe harbor essentially continues the Notice 88-128 safe harbor for 1980 CSO contracts, but recognizes a sunset date of Dec. 31, 2008 to correspond with the Jan. 1, 2009 required date for use of the 2001 CSO Tables in the NAICs model regulation. Notice 2006-95 then provides an additional safe harbor for 2001 CSO contracts under which a mortality charge is treated as meeting the reasonable mortality charge rule if:

- the charge does not exceed 100 percent of the applicable mortality charge set forth in the 2001 CSO Tables;
- the charge does not exceed the mortality charge specified in the contract at issuance;<sup>16</sup> and
- either the contract is issued after Dec. 31, 2008, or the contract is issued before Jan. 1, 2009, in a state that permits or requires the use of the 2001 CSO Tables at the time the contract is issued.

This 2001 CSO safe harbor reflects the 2001 CSO Model Regulation's required use of the 2001 CSO Tables for valuation and nonforfeiture purposes for contracts issued on and after Jan. 1, 2009. In adopting this effective date structure, Notice 2006-95 helps avoid an inconsistency between tax requirements under section 7702 and state nonforfeiture law requirements.<sup>17</sup>

### **Material Change Rules**

One aspect of the IRS's safe harbors contained in all three notices is the inclusion of special rules that treat a contract as newly issued for purposes of the safe harbors if certain types of changes are made to a contract. These material change rules serve to limit the scope of contracts that can take advantage of the safe harbors. They also have had the perhaps unintended effect of altering the manner in which some insurers administer their blocks of insurance in force. In particular, insurers now are often reluctant to allow changes to contracts in the absence of an express contractual right if new issue treatment would result in loss of safe harbor protection, even though the insurer may have maintained a long-standing practice of permitting those types of changes. As discussed below, a key question for future IRS guidance is whether modification of this material change rule is appropriate, especially in that it is difficult to reconcile with

the statute (including the adjustment mechanism contained in section 7702) and in this context appears to serve little if any tax policy purpose.

The material change rules of Notice 2006-95 begin by providing that the issue date of a contract should be determined “according to the standards that applied for purposes of the original effective date of § 7702.”<sup>18</sup> The notice then elaborates by observing that new issue treatment is accorded to exchanges of contracts and that “a change in an existing contract is not considered to result in an exchange if the terms of the resulting contract (that is, the amount and pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, and mortality and expense charges) are the same as the terms of the contract prior to the change.”<sup>19</sup> Section 5.02 of Notice 2006-95 then provides that,

“[n]otwithstanding section 5.01, if a life insurance contract satisfies [the 1980 CSO safe harbor] when originally issued, a change from previous tables to the 2001 CSO tables is not required if (1) the change, modification, or exercise of a right to modify, add, or delete benefits is *pursuant to the terms of the contract*; (2) the state in which the contract is issued does not require use of the 2001 CSO Tables for that contract under its standard valuation and nonforfeiture laws; and (3) the contract continues upon the same policy form or blank.” [Emphasis added.]

Finally, section 5.03 of Notice 2006-95 offers examples of changes that pursuant to section 5.02 would not result in new issue treatment of a contract. Specifically, Notice 2006-95 section 5.03 states:

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

Since section 5.03 of the notice provides examples (rather than a substantive rule) and references “changes, modifications, or exercises of contractual provisions” under section 5.02 of the notice, it appears necessary that the criteria of section 5.02 of the notice be met in order for a transaction to fall within the ambit of the examples identified in section 5.03 of the notice. Thus, for example, there must be a contractual right to add a particular

## AGE 100 METHODOLOGIES

With the adoption of the 2001 CSO Tables, the life insurance industry had, for the first time, a standard mortality table that extended beyond the insured’s age 100. This raised a question around how the computational rules in section 7702(e) should apply, and more broadly, around how the actuarial tests under both sections 7702 and 7702A apply after age 100. Through a collaborative process between the IRS and the insurance industry, many of the questions were answered. Building on the work of the 2001 CSO Maturity Age Task Force of the Taxation Section of the Society of Actuaries, the IRS published proposed “safe harbor” rules in 2009 (Notice 2009-47) followed by a final safe harbor in 2010 (Revenue Procedure 2010-28).

More specifically, in 2005 the SOA’s Taxation Section established a task force “to propose methodologies that would be actuarially acceptable under sections 7702 and 7702A of the Code for calculations under contracts that do not provide for actual maturity before age 100.” The report was published in 2006, and the final IRS safe harbor closely followed the recommendations in the report. Revenue Procedure 2010-28 expressly acknowledged these recommendations and cited to the publication of the report in the Taxation Section’s newsletter, *TAXING TIMES*. In introducing its safe harbor rules, the revenue procedure states that the IRS “would not challenge” the qualification of a life insurance contract as meeting the requirements of section 7702 or “assert” that a contract is a modified endowment contract (by failing under section 7702A) if the contract satisfies the requirements of the statutes using all of the “Age 100 Safe Harbor Testing Methodologies.” These methodologies detail the manner in which the various calculations under section 7702 and 7702A should be performed in order to fall within the safe harbor’s ambit. The guiding principle of these methodologies is that calculations under sections 7702 and 7702A must abide by the statutory computational rule that restricts the deemed maturity date to no later than the insured’s age 100. This is the case even if, for example, the result is a 6-pay premium under section 7702A in the case of a material change at the insured’s age 94.

rider in order for the addition of the rider not to trigger new issuance treatment for purposes of the notice.<sup>20</sup> Similarly, if a contractual right exists, is exercised, and the criteria of section 5.02 of the notice is otherwise satisfied, then the transaction would not trigger new issuance treatment, even though the transaction





may not be listed among the examples in section 5.03 of the notice, *e.g.*, a reinstatement pursuant to a contractual right after the 90 day period referenced in section 5.03 of the notice.

#### THE NEED FOR IRS GUIDANCE FOR THE TRANSITION TO THE 2017 CSO TABLES

##### **Need for a New Safe Harbor is Time Sensitive**

Given that the 2017 CSO Tables are available for use for contracts issued on and after Jan. 1, 2017, the most important and pressing need is for IRS guidance that provides a safe harbor for use of the 2017 CSO Tables for purposes of calculations under sections 7702 and 7702A. In that insurers are, with reason, wary of the imprecise standards articulated by the permanent and interim mortality rules and must necessarily adopt specific mortality assumptions for these calculations, it would be most helpful if this guidance could be issued prior to the Jan. 1, 2017 effective date.<sup>21</sup>

##### **Need for Reconsideration of Material Change Rule**

We also think that the time is ripe for reassessing the role of the material change rules currently incorporated into Notice 2006-95 and encourage inclusion of a revised structure—and one we believe is more in accord with the statute—in new IRS guidance. In the discussion below, we offer thoughts on both technical and tax policy considerations that are relevant to the material change rule issues.

##### **Technical Considerations for Material Change Rule**

The application of section 7702 to a contract, and also the identity of the prevailing mortality table within the meaning of section 7702(c)(3)(B)(i), are based on the “issue date”<sup>22</sup> of the contract. The DEFRA legislative history offers some commentary regarding the meaning of a contract’s “issue date.” This legislative history, in commenting on the effective date rule for section 7702, also indicates that a change to a pre-DEFRA life insurance contract (*i.e.*, generally a contract issued before 1985) can result in new issue treatment of a contract, so that the contract would become subject to section 7702.<sup>23</sup> As previously noted, all three IRS notices providing safe harbors for purposes of the reasonable mortality rule cross-reference the section 7702 effective date standard for identifying a contract’s “issue date.” At issue is whether this standard is appropriate and should continue.

A troubling consequence of this cross-reference is that it often can create a disconnect between a contract’s “issue date” that generally applies for purposes of section 7702 and the “issue date” that applies for purposes of the safe harbor. The purpose of the section 7702 effective date—and especially of its legislative history commentary regarding material changes – was to ensure that taxpayers could not avoid the Congressional purpose in enacting the actuarial requirements of section 7702 by making changes to a pre-DEFRA contract. Thus, for example, an increase in a pre-DEFRA contract’s death benefit other than pursuant to a contractual right after the effective date of section 7702 would cause the contract to be newly issued at the time of the increase based on this legislative history, so that the contract would become subject to section 7702 and its actuarial limitations. In contrast, there is no indication in the legislative history that such a change to a post-DEFRA contract (*i.e.*, a contract that is subject to section 7702 when originally issued) would result in a newly issued contract. Instead, such a change seemingly should be addressed by the adjustment rule of section 7702(f)(7)(A), which is the specific statutory rule mandated by Congress to apply in this circumstance.<sup>24</sup> Thus, in this example, the increase in death benefit other than pursuant to a contractual right would not affect the contract’s “issue date” that generally applies for purposes of section 7702, but it would result in a change in the contract’s “issue date” for purposes of the notice safe harbors.

In most cases, this potential disconnect never arises, since insurers generally strive to satisfy the requirements of the safe harbors and thus often restrict post issuance changes to ones for which there is a contractual right, at least in circumstances where the currently prevailing mortality table at the time of a proposed change differs from the prevailing mortality table at issue. However, a number of conundrums arise where such disconnect does arise. If a transaction causes a contract to be newly issued for purposes of the notice (and assuming the insurer wants to use the safe harbors provided by IRS notices),



an initial key question when a change is made not pursuant to a contractual right is whether the insurer should treat the contract as newly issued for purposes of the entirety of section 7702, despite the points noted above. If so, this arguably would mean that new guideline premiums would be determined for the contract taking into account the insured's current attained age. In this regard, the new attained-age guideline single premium may exceed the previously applicable guideline single premium, thus potentially increasing the contract's investment orientation. Also, in the case of a contract with a low cash value, the effective investment orientation may increase since new issue treatment may allow greater funding of the contract going forward (since that cash value would be the only amount that initially increases "premiums paid" under section 7702(f)(1)). Alternatively, should the adjustment rule of section 7702(f)(7)(A) apply to account for the change, perhaps on the theory that the contract is newly issued solely for purposes of section 7702(c)(3)(B)(i) but not otherwise under section 7702?<sup>25</sup>

Having to deal with the notices' material change rules adds considerable complexity to the administration of life insurance contracts with the requirements of the statutes, which are intricate even without this additional burden. This raises the question, discussed next, of whether any material tax policy goal is being served by the imposition of the notices' material change rules and their departure from section 7702's otherwise applicable adjustment regime.

#### **Tax Policy Considerations for Material Change Rule**

Because the provision of a safe harbor is a matter of administrative grace, the IRS is able to impose a material change standard which, as discussed above, departs from the otherwise applicable

regime for addressing post-issuance changes to a contract prescribed by section 7702(f)(7)(A). At issue, however, is whether imposition of the material change rules furthers a material tax policy goal. As discussed above, the notices' material change rules cross-reference the effective date rule of section 7702 and its legislative history, and the material change rule that applied for that purpose (as described by the DEFRA legislative history) was intended to prevent taxpayers from avoiding Congress' newly enacted restrictions on life insurance investment orientation. In this respect, the section 7702 effective date rule is similar to many effective date rules that apply to newly enacted provisions of the IRC. Transitions from one prevailing mortality table to another, however, are fundamentally different in nature from a statutory change.

A change from one prevailing mortality table to another is not a circumstance where Congress has acted to preclude or limit a prior practice. Rather, changes in prevailing mortality tables arise from actions taken by the actuarial profession and ultimately the NAIC in recognition of changes in life expectancy for the insured population over time. There is no tax rule dictating the frequency with which mortality tables need to be reevaluated. Further, while changes to the tables in the past have generally reflected improved life expectancy, there is no assurance that this will continue to be the case.<sup>26</sup> One might also reasonably expect that the magnitude of changes in tables over time will become less significant than they have been in the past. Perhaps most importantly, policyholders generally are unaware of changes in prevailing mortality tables. Thus, when policyholders do request changes to their contracts that are not pursuant to an existing contractual right, this action commonly is sought due to considerations having nothing to do with the change in prevailing

mortality tables. Rather, a policyholder may desire lower rates (such as when requesting a change in guaranteed rates) or may desire a change in the level of coverage to address his or her changing needs.

This raises the further consideration regarding the types of changes that commonly implicate the notices' material change rules. For most universal life insurance policies (which by their nature are flexible), contractual rights typically exist for many types of contractual changes, including for increases and decreases in death benefits. For some contracts, there may not be a right to change the mortality guarantees (*e.g.*, from smoker to non-smoker status or dropping of a rating based on improved health). Under the adjustment rule of section 7702(f)(7)(A), such changes would result in a reduction in the contract's guideline premiums or net single premium, *i.e.*, there would be a reduction in investment orientation. Also, addition of a qualified additional benefit is another common change to universal life insurance contracts that often is not made pursuant to a contractual right; however, in that the reasonable expense charge rule applies to account for the charges for such riders,<sup>27</sup> there is little if any opportunity for increasing a contract's investment orientation through the addition of such a rider. Similarly, while whole life insurance contracts are less flexible in nature, insurers may have a practice of allowing certain changes such as a reduction in death benefit even in the absence of a contractual right to do so. Such changes are usually driven by non-tax considerations (such as affordability) and may result in a reduction in the contract's investment orientation after application of the adjustment rule. In each of these instances, there is no material tax policy reason to treat the contract as newly issued.<sup>28</sup>

[A] key question for future IRS guidance is whether modification of [the] material change rule is appropriate ...

It is not clear what policy is achieved by applying the DEFRA effective date material change standard to alter a post-DEFRA contract's "issue date" for purposes of identifying the applicable prevailing mortality table. The standard was put in place due to a concern about abuse involving pre-DEFRA contracts. In the case of a post-DEFRA contract, however, there is little if any opportunity for abuse. The safe harbors of the various notices have provided beneficial clarifications to the industry. However, the tax policy considerations associated with a new

statutory enactment are fundamentally different from a change in mortality tables. Thus, the notices' reliance on the section 7702 effective date rule is an aspect of the safe harbors that needs revision.<sup>29</sup>

#### IMPACT OF THE 2017 CSO TABLES ON THE SECTION 7702 AND 7702A FUNDING LIMITATIONS

Like the 2001 CSO Tables, the 2017 CSO Tables are a collection of mortality tables, varying in structure and risk classification. In total, the Society of Actuaries has published 104 mortality tables, including variations based on the following characteristics:

- Age-last and age-nearest birthday
- Select and ultimate
- Sex-distinct and gender-blended
- Composite and smoker-distinct
- Preferred risk classes for both nonsmoker (three classes) and smoker (two classes) risk classes

The consistency in structure with the 2001 CSO Tables, including a terminal age of 121, will lessen to some extent the administrative burden associated with the transition to the 2017 CSO Tables. This should somewhat ease the burden on those responsible for policyholder administration systems, particularly for those who may have been involved in the transition to the 2001 CSO Tables who had to address then for the first time a mortality table that extended beyond age 100. Even with these considerations in mind, transition to the new tables nonetheless will present challenges and require devotion of substantial resources, especially given the related work involved with implementation of principle-based reserving.

As noted above, by referencing the prevailing table as of a contract's issue date, section 7702(c)(3)(B)(i) has a built-in mechanism for reflecting mortality improvements in the section 7702 funding limitations for newly issued contracts. The 2001 CSO Tables generally resulted in mortality improvements for virtually all risk classes relative to the 1980 CSO Tables, but such improvements varied in magnitude across risk classes, as would be expected. This resulted in across-the-board reductions to guideline premiums, net single premiums, and 7-pay premiums averaging in the 15 to 20 percent range,<sup>30</sup> with marginally higher reductions for males and lower reductions for smoker risk classes. The 2017 CSO Tables will again have a similar effect on the section 7702 and 7702A funding limitations, layering an additional 10 to 15 percent reduction on top of those realized from the transition to the 2001 CSO Tables. Since the enactment of the reasonable mortality requirements in 1988, funding limitations under sections 7702 and 7702A will have experienced reductions in the range of 25 to 35 percent due solely to mortality improvements reflected in prevailing tables.



Companies are now planning their three year strategy for transitioning their product portfolio to become 2017 CSO compliant, *i.e.*, before the Jan. 1, 2020 deadline when use of the 2017 CSO Tables becomes mandatory. Because the 2017 CSO Tables will generate reduced valuation and minimum nonforfeiture values for traditional products such as term and whole life insurance, we would expect companies issuing these products to be early adopters of the 2017 CSO Tables, particularly with respect to their products with lesser investment orientation that benefit from reduced premiums and lower valuation requirements. Issuers of more investment focused nontraditional products like universal and variable universal life that tend to rely on the guideline premium test are likely to wait a little longer. As discussed further below, the 2017 CSO Tables may not be as welcomed for developers and purchasers of such products, particularly for policyholders seeking a greater investment orientation while still desiring lifetime death benefit protection.

The guideline premium test sets forth funding limitations in the form of endowment premiums (single and level premium) that are calculated based on prescribed assumptions for interest, mortality and expenses. In this regard, any experience realized that is more “favorable” than the prescribed assumptions (*e.g.*, mortality charges that are less than those reflected in the calculation of guideline premiums) will increase the likelihood that the policy will generate cash values that allow for maturity of the contract. On the contrary, less favorable experience (*e.g.*, crediting interest at a rate that is less than the interest rate reflected in the calculation of guideline premiums) will reduce the likelihood for such cash value generation. Using the concept of a “margin” to describe differences between actual and prescribed

assumptions underlying the section 7702 calculations, the discussion below explores some of the potential consequences that may emerge for guideline premium test contracts based on the 2017 CSO Tables.

While it may take several years or more to reflect mortality improvements in standard industry mortality tables, companies generally respond more quickly in building mortality improvements into their product designs. We would therefore not expect the 2017 CSO Tables to produce significant changes in the operation of universal life insurance contracts, as most companies have already reflected these mortality improvements through reduced current cost of insurance charges for their products. The biggest impact of the 2017 CSO Tables from a product design perspective will likely be in the form of reduced “mortality margins” (*i.e.*, the excess of reasonable mortality charges based on 2017 CSO Tables that are reflected in guideline premiums over the cost of insurance charges currently imposed), which will likely play an important role in a policyholder’s ability to fund universal life insurance contracts in today’s low interest rate environment.

With the implementation of the 2001 CSO and 2017 CSO Tables, there have been significant corresponding reductions in the magnitude of the mortality margin. As noted above, the combined impact that both the 2001 and 2017 CSO Tables have had on guideline premiums has resulted in a 25 to 35 percent average reduction for many risk classes relative to their 1980 CSO counterparts. To put these reductions in perspective, they are roughly the same magnitude as a 1 percent reduction in the credited rate below the statutory minimum rates of 6 percent for the guideline single premium and 4 percent for

the guideline level premium, *i.e.*, a negative 1 percent interest margin. Put differently, the additional premium required to endow a contract under a negative 1 percent interest margin increases 25 to 50 percent on a single premium basis and 15 to 40 percent on a level premium basis (percentages decrease as issue ages increase).

While 1980 and 2001 CSO products likely still have some measurable mortality margin to help offset any negative interest rate margin that currently exists on products crediting less than 4 percent interest, policyholders will likely find it increasingly challenging to fund 2017 CSO guideline premium test contracts, and thus there is a substantially increased risk that contracts will be in an underfunded status in later policy durations even if they have funded their contracts at or near the guideline premium limit. Section 7702(f)(6) provides some relief, by allowing for the payment of premiums to keep a contract in force that would otherwise exceed the guideline premium limitation. However, the additional restrictions imposed by section 7702(f)(6) that prevent the build-up of any cash value makes this an expensive alternative, essentially requiring that the contract be administered as a term insurance policy for as long as the policyholder can afford the coverage.

Companies are likely to respond to these funding concerns by continuing to offer “no-lapse guarantee” features on universal life products that will provide assurances to policyholders that their contracts will remain in force through at least the no-lapse guarantee period, regardless of the underlying performance of the contract’s cash value. Companies also may respond by developing universal life products that are designed to comply with the cash value accumulation test, as this design may provide a better long-term funding solution in today’s low interest rate environment (since this test does not impose any direct limitation on premiums). However, universal life designs based on the cash value accumulation test are not without their own administrative challenges. First, such contracts require more insurance risk (*i.e.*, net amount at risk, or the excess of the death benefit over the contract’s cash value) than their guideline premium test counterparts in the older age durations when mortality costs become progressively more expensive. The other important consideration in a universal life cash value accumulation test design relates to application of the necessary premium test of section 7702A(c)(3)(B)(i). Monitoring compliance with the necessary premium test is required to properly identify when material changes, within the meaning of section 7702A(c)(3), arise and ultimately if and when a contract becomes a modified endowment contract, or MEC, under section 7702A. Given that most universal life insurance contracts on the market today are designed to qualify under the guideline premium test, policyholder administration systems may not currently have the appropriate func-

tionality to support administration of the necessary premium test for flexible premium cash value accumulation test products. This is because the necessary premium test functions in a substantially different manner for such products compared with the test’s application to guideline premium test products. While a cash value accumulation test design may ultimately prove to be a better alternative for addressing long term funding concerns, companies will need to tread carefully into the cash value accumulation test realm for universal life and other flexible premium designs and do their due diligence to fully understand the implications and administrative trade-offs for this design.

## CONCLUDING THOUGHTS

The new 2017 CSO Tables are upon us, and insurers are already well into the process of evaluating the effects of the new tables on their product portfolios. Action by the IRS in the form of a safe harbor for use of the 2017 CSO Tables will facilitate this transition by providing needed certainty to the industry (and hopefully reconsideration of the material change rules will reduce the burden on insurers associated with administering the requirements of sections 7702 and 7702A). Significantly, the 2017 CSO Tables meaningfully reduce the funding limitations under section 7702 and 7702A, which makes product design even more challenging in the current low interest rate environment. While different design options may help address these funding concerns, they come with their own difficulties which insurers will need to navigate. ■

**Note:** The views expressed are those of the authors and do not necessarily reflect the views of Davis & Harman or Ernst & Young LLP.

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## ENDNOTES

- <sup>1</sup> MDL-820 (2010).
- <sup>2</sup> MDL-814 (2003).
- <sup>3</sup> See § 11B and 11C of the Standard Valuation Law and drafting note thereto; § 5cH(6) of the Standard Nonforfeiture Law for Life Insurance, MDL-808 (2014).
- <sup>4</sup> While the accelerated adoption process provided by the *Valuation Manual* is beneficial from an efficiency perspective, it raises some concerns in that it may not provide sufficient time for companies to develop products and conform valuation and administrative systems to new tables; there also may be less time for the IRS to provide any needed guidance on new tables from both a valuation and product tax perspective. To alleviate some of these concerns, guidance notes were added to VM-02 and VM-20 of the *Valuation Manual* that recommend a timeframe for new table adoption. Interestingly, for the 2017 CSO tables, the permitted use date ultimately adopted did not adhere to this timeframe, due in part to the desire of the NAIC to have the permitted date for the 2017 CSO Tables coincide with the operative date of the *Valuation Manual*.
- <sup>5</sup> PUB. L. NO. 98-369.
- <sup>6</sup> See § 5011(a) of the Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647 (TAMRA), which is effective for contracts entered into on or after Oct. 21, 1988. For earlier issued contracts, the statute permitted reflection of “mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract).”
- <sup>7</sup> In this regard, the TAMRA legislative history provides that any “[s]tandards set forth in such regulations that limit mortality charges to amounts less than those specified in the prevailing commissioners’ standard tables are to be prospective in application.” H.R. REP. NO. 100-1104, PT. 2, at 108 (1988) (Conf. Rep.).
- <sup>8</sup> 1988-2 C.B. 540.
- <sup>9</sup> For those readers interested in additional background and a more in depth analysis of the prior mortality table guidance issued by the IRS, we recommend the following *TAXING TIMES* articles: “Life Beyond 100: Rev. Proc. 2010-28 Finalizes the “Age 100 Methodologies” Safe Harbor,” Feb. 2011; “IRS Issues Proposed Safe Harbor Prescribing “Age 100 Methodologies,”” Sept. 2009; “More on Reasonable Mortality: IRS Issues Notice 2006-95,” Feb. 2007; and “Evolution of Mortality Requirements under Sections 7702 and 7702A of the Internal Revenue Code,” May 2005. See also “Life Insurance & Modified Endowment under Internal Revenue Code Sections 7702 and 7702A (2d ed. 2015).”
- <sup>10</sup> See NAIC Model Rule (Regulation) Permitting Smoker/Non smoker Mortality Tables for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits, MDL-812 (1984).<sup>1</sup> MDL-820 (2010).
- <sup>11</sup> See, e.g., *Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans, etc., et al. v. Norris, etc.*, 463 U.S. 1073 (1983). See also Notice 2006-95, discussed below.
- <sup>12</sup> Prop. Treas. Reg. § 1.7702-1(b).
- <sup>13</sup> 2004-2 C.B. 596.
- <sup>14</sup> 2006-2 C.B. 848.
- <sup>15</sup> For example, Notice 2006-95 clarified that an increase in death benefit with underwriting provided pursuant to the terms of a contract would not cause a contract to be treated as newly issued. Also, Notice 2004-61 had expressly permitted the use of smoker-distinct and gender-blended mortality tables, but only if the insurer used such tables consistently for all contracts under a plan of insurance (as foreshadowed in the 1991 proposed regulations on reasonable mortality). Notice 2006-95 retains this consistency requirement, but only for purposes of the 2001 CSO safe harbor so as not to impose retroactively an additional requirement.
- <sup>16</sup> Notice 2006-95’s requirement for the 2001 CSO safe harbor that mortality charges assumed not exceed the mortality charges specified (*i.e.*, guaranteed) in the contract was not a limitation for Notice 88-128’s 1980 CSO safe harbor. Thus, in applying the 2001 CSO safe harbor, special care should be taken to ensure that any contractual guarantees of mortality charges less than charges based on 100 percent of the 2001 CSO Tables are reflected in calculations under sections 7702 and 7702A.
- <sup>17</sup> Taking into account the three year transition rule of section 807(d)(5)(B), the permanent mortality charge rule of section 7702(c)(3)(B)(i) limited mortality charges to those based on the 2001 CSO Tables for contracts issued on and after Jan. 1, 2008. The 2001 CSO safe harbor of Notice 2006-95 extends this effective date, *i.e.*, to contracts issued on and after Jan. 1, 2009, assuming the requirements for use of the safe harbor are met. This latter point is especially significant for contracts based on the 1980 CSO Tables issued during 2008, since use of the 1980 CSO Tables for calculations under sections 7702 and 7702A is only allowed under the permanent mortality rule if the requirements of the safe harbor are met, including the notice’s material change rules which are discussed below.
- <sup>18</sup> Notice 2006-95, section 5.01.
- <sup>19</sup> *Id.*
- <sup>20</sup> See, e.g., PLR 201230009 (Jan. 30, 2012) (treating a reduction in death benefit under a life insurance contract that was not made pursuant to a contractual right as causing the contract to be newly issued for purposes of § 5 of Notice 2006-95).
- <sup>21</sup> It also would be useful to confirm that the safe harbor provided by Rev. Proc. 2010-28 for the Age 100 Safe Harbor Testing Methodologies continues to apply for contracts utilizing the 2017 CSO Tables.
- <sup>22</sup> The Blue Book explanation of DEFRA observes that “[f]or purposes of applying the [effective date of section 7702] ... the issue date of a contract is generally the date on the policy assigned by the insurance company, which is on or after the date the application was signed. ...” See STAFF OF THE J. COMM. ON TAX’N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 655 (Comm. Print 1984) (DEFRA Blue Book). Also, a footnote to this sentence in the DEFRA Bluebook states that “[t]he use of the date on the policy would not be considered the date of issue if the period between the date of application and the date on which the policy is actually placed in force is substantially longer than under the company’s usual business practices.” *Id.*
- <sup>23</sup> See S. PRT. NO. 98-169, VOL. I, at 579 (1984) (stating: “Contracts issued in exchange for existing contracts after Dec. 31, 1984 are to be considered new contracts issued after that date. For these purposes a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange”); DEFRA Blue Book at 656 (stating: “The exercise of an option or right granted under the contract as originally issued does not result in an exchange and thus does not constitute the issuance of a new contract for purposes of new section 7702 and any applicable transition rules if the option guaranteed terms that might not otherwise have been available when the option is exercised. . .”).
- <sup>24</sup> This treatment also accords with section 7702(a), which provides that a “life insurance contract” as defined in section 7702 must constitute a life insurance contract under applicable law (generally state law). Since the contract that is a life insurance contract under applicable law is the foundation to which section 7702’s actuarial tests are applied, it follows that if a change does not cause a contract to be treated as a newly issued under state law, it would not be treated as newly issued for purposes of section 7702(a) or otherwise for purposes of section 7702. Of course, if a change did cause the contract to be newly issued under state law, it similarly would be treated as newly issued for purposes of section 7702.
- <sup>25</sup> Yet another question is how a change not made pursuant to a contractual right should be addressed in circumstances where there has been no change in the prevailing mortality table between the original issuance of the contract and the date of the change. Seemingly, there is no need for new issuance treatment in this circumstance, and the adjustment rule would apply to account for the change. However, the notices’ material change rules and their reliance on the section 7702 effective date rule do not expressly distinguish this situation.
- <sup>26</sup> If a future mortality table generally reflects worsening mortality, and correspondingly allows for greater contract investment orientation under section 7702, one wonders whether the IRS will continue in its viewpoint as expressed in the existing material change rules.
- <sup>27</sup> See Rev. Rul. 2005-6, 2005-1 C.B. 471.
- <sup>28</sup> Changes to the legal entitlements of a contract can cause the contract to be treated as a new property for tax purposes. See, e.g., *Cottage Savings Association v. Comm’r*, 499 U.S. 554, 565 (1991). However, the applicable law rule of section 7702(a) and the adjustment rule of section 7702(f)(7)(A) prescribe more specific statutory rules to address the meaning of a contract’s “issue date” and the effect of changes on the actuarial limitations applicable to a contract.
- <sup>29</sup> At a minimum, it would be helpful if guidance clarified that various common transactions do not result in new issue treatment of a contract even if not made pursuant to the terms of a contract, such as changes in smoking status and ratings based on improved health, death benefit reductions, the addition of qualified additional benefits, and any change that would not be taken into account in applying the statute’s actuarial limitations in any event.
- <sup>30</sup> For this analysis, the impact of new mortality tables on the section 7702 and 7702A funding limits is based on the calculation of guideline, net single and 7-pay premiums assuming no expenses or charges for qualified additional benefits, and interest at the statutory minimum rate of 4 percent for the guideline level, net single and 7-pay premiums and 6 percent for the guideline single premium. As improvements are reflected in the mortality used to calculate these values, the impact of including expenses (in the case of guideline premiums only) and charges for qualified additional benefits in the calculations will generally serve to increase these values. For most universal life insurance contracts, however, the impact of mortality improvements on the funding limitations from expenses and charges for qualified additional benefits (which results in an increase in the funding limits relative to those under the prior tables) is generally not material relative to the impact that mortality improvements have on death benefits (which results in a decrease in the funding limits relative to those under the prior tables).

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# In the Beginning... A Column Devoted to Tax Basics Requesting Guidance from the IRS

By Dan Phillips

A previous “In the Beginning . . .” column (May 2014) discussed the hierarchy of authorities that establish and interpret federal tax law. To recap: (i) tax laws are passed by Congress and signed by the president, (ii) regulations, which interpret and expand on the law, are written by the IRS together with the Treasury Department, and (iii) additional guidance is issued by the IRS in various forms, including revenue rulings, revenue procedures, private letter rulings (PLRs), technical advice memoranda (TAMs), and notices.

This column will discuss how a taxpayer can solicit guidance from the IRS. For this purpose, IRS guidance generally falls into three categories: (i) published guidance in the form of regulations, revenue rulings, revenue procedures, and notices, (ii) PLRs, which rule on the tax treatment of a specific transaction or activity of a taxpayer that is not yet reflected on a tax return, and (iii) TAMs, which rule on the tax treatment of a transaction or activity in which the taxpayer has already engaged and is reflected on its tax return.

The guidance in the first category is published in the IRS’s *Internal Revenue Bulletin* and is applicable to all taxpayers. PLRs and TAMs are generally only applicable to a specific taxpayer and are released in redacted form by the IRS but are not officially published.

## PUBLISHED GUIDANCE

Taxpayers can solicit published guidance from the IRS by requesting additions to the IRS’s Business Plan or by requesting acceptance of an issue in the IRS’s Industry Issue Resolution program.

### Requesting Additions to Business Plan

Each year the IRS releases its Priority Guidance Plan—more commonly known as the Business Plan—that lists the topics on which the IRS and Treasury Department plan to publish guidance. This is the IRS’s “to do” list. The Business Plan is broken down by subject area, one of which is Insurance Companies and

Products. Items from other categories (e.g., Employee Benefits and Corporations and their Shareholders) may also affect insurance companies. The items in the Insurance Companies and Products category of the current Business Plan are:

- Final regulations under section 72 on the exchange of property for an annuity contract,
- Regulations under sections 72 and 7702 defining cash surrender value,
- Guidance on annuity contracts with a long-term care insurance rider under sections 72 and 7702B,
- Guidance under sections 807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principles-based methodologies, including stochastic reserves based on conditional tail expectation,
- Guidance under section 833,
- Guidance on exchanges under section 1035 of annuities for long-term care insurance contracts, and
- Guidance relating to captive insurance companies.

Prior to each year’s release of the Business Plan, the IRS publishes a notice requesting recommendations from the public for items to be included in the Business Plan. This is the taxpayer’s opportunity to request guidance on a particular issue. The requests need not be in any particular format, but the IRS asks that the request include an explanation as to why the guidance is needed, an analysis of how the issue should be resolved, and if multiple requests are made, a ranking of the priority of the requests.

Many requests for the inclusion of items on the Business Plan are submitted to the IRS each year. There are usually a couple of requests for insurance items; these are typically submitted by insurance or annuity company trade associations.

The IRS usually only publishes one or two items of guidance from the insurance portion of the Business Plan each year. This guidance is generally in the form of a regulation, revenue ruling, revenue procedure, or notice and is published in the IRS’s *Internal Revenue Bulletin*. Regulations can be quite complex and lengthy elaborations of the often vague tax law and frequently have short illustrative examples. Revenue rulings are generally a few pages long and have a simple hypothetical fact pattern, a discussion of the relevant law, and a conclusion on how some aspect of the fact pattern should be treated for tax law purposes.



Revenue procedures describe procedures that a taxpayer should follow to participate in some IRS program or obtain some defined result. Notices pertain to a substantive tax issue and are often interim guidance, including describing the content of a regulation that may be published in the near future.

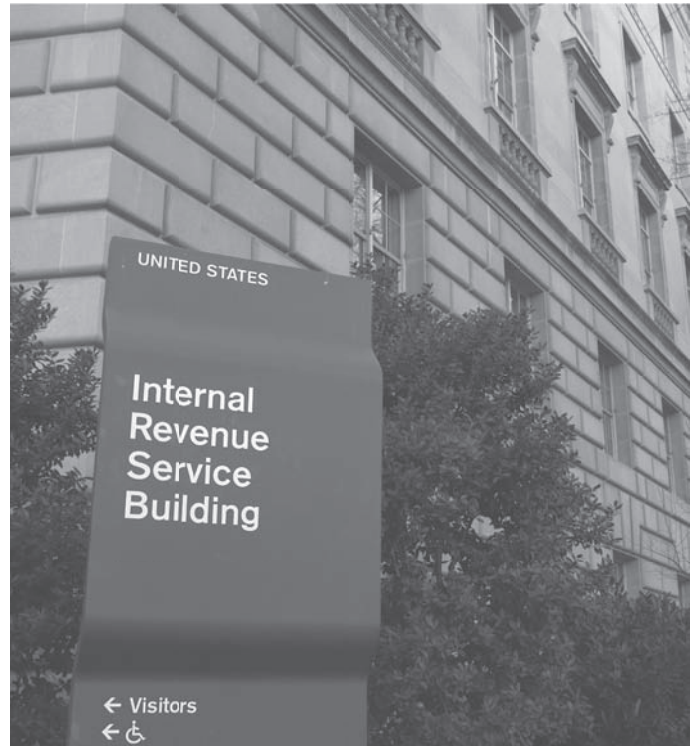
Only one or two insurance items are generally added to the Business Plan each year. These items may be taken from requests made by taxpayers or added at the IRS's own initiative. When determining what items to add to the Business Plan, the IRS considers what issues might be significant to a large number of taxpayers, whether the guidance will reduce controversy and lessen the burden on taxpayers and IRS, and the IRS's competing priorities.

### Requesting Acceptance in the Industry Issue Resolution Program

Another avenue for soliciting published guidance from the IRS is through the IRS's Industry Issue Resolution (IIR) program.<sup>1</sup> The IIR program allows industry groups to collaborate with the IRS to resolve frequently disputed or burdensome tax issues that affect a significant number of taxpayers in an industry. The resolution of an issue frequently takes the form of published guidance but may also be a directive to field offices of an operating division of the IRS (*i.e.*, to the IRS personnel that actually examine tax returns and propose adjustments) that the issue be handled in a prescribed manner.

A request that an issue be accepted in the IIR program need not be in a particular format but the IRS does ask that requests be made by an industry group (*e.g.*, a trade association or ad hoc group) representing a cross section of the affected industry and that requests include an explanation of the issue, a statement as to why the issue is appropriate for the IIR program, and an explanation of how the requester recommends the issue be resolved. The IRS is not obligated to accept an issue into the program. In determining whether to accept an issue into the IIR program, the IRS considers, among other things, (i) whether the proper tax treatment of the issue in a common factual situation is uncertain, (ii) whether the uncertainty results in repetitive examination of the issue for many taxpayers, requiring significant resources of both the IRS and taxpayers, and (iii) whether collaboration with the industry would facilitate a proper resolution of the issue by promoting an understanding of taxpayer views and business practices. The IRS only accepts a few issues into the program each year.

Once an issue is accepted, the IRS selects a team to analyze the issue and develop appropriate guidance. The team is drawn both from industry and from various offices of the IRS and Treasury Department. The industry team members are expected to actively participate and may be requested to provide in-



formation about industry practice and from books and records of specific taxpayers. This is often necessary because the issues usually accepted in the IIR program are those that involve a unique industry issue or practice with which the IRS may not be familiar or have expertise. The industry's active involvement in resolving the issue distinguishes the IIR program from the process by which guidance is developed and published from the Business Plan.

The process of reaching a resolution and developing appropriate guidance may take a year or more. The insurance industry has twice used the IIR program successfully as described in previous *TAXING TIMES* articles.<sup>2</sup>

Obtaining published guidance by requesting that items be added to the IRS's Business Plan or by seeking acceptance of an issue in the IIR program is neither certain nor fast. Requesting published guidance is most appropriate for industry-wide issues. If a taxpayer needs guidance that is relatively quick or specific to its circumstances, the taxpayer will have more luck seeking a PLR.

### PRIVATE LETTER RULINGS (PLRs)

A PLR is the IRS's written response to a taxpayer's request for a ruling on how a planned or completed transaction or other activity that has not yet been reflected on a tax return should be treated for tax purposes.<sup>3</sup> PLRs are generally several pages long, have a summary of the relevant facts, a discussion of the appli-

cable law, a list of specific facts that the taxpayer has represented (and the IRS has assumed) to be true, and a list of rulings or legal conclusions about the treatment of the transaction or activity.

A request for a PLR is made to the part of the IRS's Chief Counsel Office that specializes in the subject matter related to the PLR request.<sup>4</sup> The IRS's Chief Counsel Office has within it seven Associate Chief Counsel Offices (Associate offices), each of which specializes in a particular tax area. Branches within each Associate office are further specialized.

A request is formally made to the appropriate Associate office and is handled by the particular branch that specializes in the subject matter. For example, if a taxpayer were to submit a PLR request about an insurance issue, it would be submitted to the Associate office for Financial Institutions and Products and would be handled by its insurance branch. Multiple Associate offices may be involved if the PLR request involves more than one area of tax, *e.g.*, insurance and international tax.

A request for a PLR must include a statement of the taxpayer's business, an explanation of the reasons for the transaction or activity, all the relevant facts and documents, an analysis of the material facts, an analysis of the requested legal conclusion, all relevant legal authorities, and certain procedural statements. This submission might be compared to a brief submitted to a court in litigation. All of this must be submitted under penalties of perjury. The taxpayer frequently provides a draft of the proposed PLR to the IRS. The IRS is obviously not required to use all or any part of this draft, but it may save the IRS time. The taxpayer is usually happy to provide a draft because it is then more likely to receive a PLR that best addresses the issues raised.

The IRS has understandably placed significant limitations on the circumstances in which it will issue a PLR, and resource constraints in recent years have also significantly diminished the number of PLRs it can issue. The IRS will generally not issue a PLR in the following situations, among others:

- when the same issue is involved in a tax return for an earlier year and that issue is being examined by the IRS, being appealed within the IRS, or is being litigated,
- when the issue is the subject of related guidance that is pending publication by the IRS,
- when the issue is particularly fact intensive,
- when the ruling sought is whether a transaction qualifies as a corporate tax-free transaction (*e.g.*, a tax-free liquidation, spin-off, or reorganization),

The IIR program allows industry groups to collaborate with the IRS to resolve frequently disputed or burdensome tax issues that affect a significant number of taxpayers in an industry.

- when the ruling involves a frivolous issue—such as whether the income tax is constitutional,
- when the tax treatment of the issue is clearly and adequately addressed by statute, IRS published guidance, or court decision (often called “comfort rulings”), and
- when issuing a PLR is not in the interest of sound tax administration.

In addition, there are many specific substantive areas in which the IRS will not issue a PLR—so called “no rule” areas.<sup>5</sup> “No rule” areas that relate to insurance include:

- whether a split-dollar life insurance arrangement is “materially modified” within the meaning of Treas. Reg. § 1.61-22(j)(2),
- whether “substantially all” the premiums of a contract of insurance are paid within a period of 4 years from the date on which the contract is purchased, and
- whether an amount deposited is in payment of a “substantial number” of future premiums on such a contract.

### The Nitty-Gritty of Obtaining a PLR

Taxpayers (and/or their representatives) often meet with the IRS for a pre-submission conference prior to the formal submission of a PLR request. The taxpayer would normally send in advance a draft or summary of the proposed PLR request to the branch handling the request. The pre-sub conference is an excellent opportunity for the taxpayer to explain the issues in a face-to-face meeting and explain (hopefully convincingly) why the IRS should grant the requested rulings (*i.e.*, the desired tax treatment). This meeting can help improve the quality of the PLR request, and the IRS may be able to suggest some changes

to the transaction or activity that would ameliorate the tax issues. The IRS may also inform the taxpayer if the IRS would not issue a PLR for some reason.

Once the actual submission is made, it usually takes six months or more (sometimes much more) for the IRS to rule. The IRS has a four to six month target for rulings, but this is frequently not met. While the PLR request is pending, the IRS may ask for additional documentation or explanations.

If the IRS proposes to rule adversely (*i.e.*, not give the taxpayer the rulings it requests), it will contact the taxpayer and propose a conference. If, after the conference, the IRS still plans to rule adversely, the taxpayer may withdraw its request for a PLR so it will not have a formal adverse ruling on record. The Associate office, however, would almost certainly inform the IRS field office (*i.e.*, the IRS office that actually audits taxpayers' tax returns) for the taxpayer that a PLR was requested, what the issues were, and that a tentative adverse ruling was proposed. Obviously, the field office would then be on the lookout for the issue.

Obtaining a PLR is not cheap. The standard fee for a PLR request is \$28,300 with lesser amounts being charged for certain simple requests. This fee is set by the IRS to cover the time and expense of the IRS personnel. Additionally, the taxpayer's lawyer or CPA may, depending on the complexity, charge a significantly greater amount for the work that goes into a PLR request.

After the PLR is released to the taxpayer, it will be released to the public. The IRS is required to redact all identifying and confidential information from the PLR before it is released to the public, and the taxpayer has the opportunity to review this redacted version and request additional redactions.

### Effect of a PLR

The ability to rely on an authority means that the IRS will not dispute the accuracy of an item on a tax return to the extent the item is based on such authority. For example, if a revenue ruling based on a hypothetical fact pattern concluded that a certain policy was insurance for tax purposes, the IRS would not dispute a taxpayer's treatment of a similar policy as insurance, unless there were some facts of the taxpayer that were meaningfully different than the facts in the revenue ruling.

In contrast to statutes, regulations, revenue rulings, revenue procedures, notices, and certain other tax guidance published by the IRS, PLRs may not be relied upon by taxpayers other than the one to whom the PLR was issued.<sup>6</sup> Every PLR states: "This ruling is directed only to the taxpayer requesting it. Section 6110(k) (3) of the Internal Revenue Code provides that it may not be used or cited as precedent." If there were a material misstate-

ment in the PLR or an intervening change in law, even the taxpayer to whom the PLR was issued could not rely on it.

Nonetheless, PLRs are generally well reasoned and reflect the IRS's analysis of a particular issue at the time the PLR was issued. Taxpayers (and their advisors) consider PLRs when coming to their own conclusions about tax issues. There is little reason to think that the IRS would come to a different conclusion with respect to one's own issue than it came to in a PLR recently issued to a different taxpayer on substantially similar facts.

Because of the time and expense involved, PLRs are generally only requested in connection with large or important transactions and activities. Frequently, a taxpayer's willingness to proceed with the transaction or activity is dependent on its obtaining a favorable PLR. The benefit of obtaining a PLR is the relative certainty of the tax treatment. The downside of requesting a PLR (apart from the time and expense) includes the possibility that (i) an adverse PLR is proposed when the taxpayer may have been able to convince the IRS field office auditing its return of the propriety of the taxpayer's treatment or (ii) the IRS may issue some other guidance or document describing the taxpayer's issue and taking an adverse position.

### TECHNICAL ADVICE MEMORANDA (TAM)

Like a PLR, a TAM is issued by an Associate office and addresses the tax treatment of a specific issue of a taxpayer.<sup>7</sup> Unlike a PLR, a TAM is requested by an IRS field office<sup>8</sup> in the course of auditing a taxpayer's return or processing a taxpayer's claim for a refund when the office needs technical assistance applying the law to the particular facts of the taxpayer. Thus, PLRs are issued for transactions and activities before the tax return is filed, and a TAM is issued when a transaction or activity has already occurred and has been reported on a tax return. TAMs are not issued if the taxpayer is litigating the same issue for any tax year.

If a field office comes across an issue with which it wishes technical assistance, it would first consult the IRS field counsel. If additional assistance is desired after such consultation, the field office may request a TAM of the appropriate Associate office. The branch within the Associate office that specializes in the relevant tax area would handle the TAM request.

A taxpayer cannot ask for a TAM directly, but it can ask the field office to request a TAM. The taxpayer may do this if it disagrees with the field office's application of the law. If the field office declines to request a TAM, the taxpayer may appeal the denial.

As a first step in requesting a TAM, the field office, field counsel, taxpayer, and assigned attorney within the branch of the relevant Associate office have a pre-submission conference to discuss the

coming request. Before the conference, each of the taxpayer and field office must submit to the Associate office a statement of facts and issues. At the conference, the parties are to determine the scope of the TAM request and the factual information that must be included in the field office's formal request for a TAM. This information would typically include a complete statement of the facts, explanation of the issues at dispute, a legal analysis, and any other helpful information.

As part of the formal request for a TAM, the field office must prepare for the Associate office a memorandum that includes the information agreed upon in the pre-submission conference. The field office is encouraged to work with the taxpayer and agree upon the facts and issues included in the memorandum. If they cannot agree, the taxpayer may submit its own memorandum to the Associate office, and in cases where the taxpayer initiated the TAM, the taxpayer must submit such a memorandum. Any submission by the taxpayer must be made under penalties of perjury.

During the course of processing the TAM, the Associate office may seek additional information or have conferences in order to further understand the facts and issues. If the IRS proposes a TAM that is adverse to the taxpayer, then, as with a PLR request, the taxpayer has the right to a conference with the IRS. The taxpayer may not withdraw a request for a TAM.

The TAM itself looks much like a PLR. It is generally several pages in length and has a summary of the relevant facts, an explanation of the issues, a discussion of the relevant law, and conclusions. The field office and field counsel are given the opportunity to review the draft TAM before its release and provide input. Once issued, the field office is bound by the conclusions in the TAM.

Before a redacted version of the TAM is released to the public, the taxpayer is given the opportunity to review it and request additional redactions. As with PLRs, a taxpayer may not rely upon a TAM issued to another taxpayer.<sup>9</sup> ■

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#### ENDNOTES

- <sup>1</sup> The Industry Issue Resolution program is described in Rev. Proc. 2016-19, 2016-13 I.R.B. 497.
- <sup>2</sup> See Eric Bisighini and Tim Branch, "Variable Annuity Hedging Directive – A Long and Winding Road," *TAXING TIMES*, Vol. 10, Issue 3 at 1 (Oct. 2014); Arthur C. Schneider and Samuel A. Mitchell, "IRS Utilizes Industry Issue Resolution Program to Resolve the Insurance Industry Bad Debt Issue," *TAXING TIMES*, Vol. 9, Issue 1 at 20 (Feb. 2013).
- <sup>3</sup> Sub-categories of PLRs not discussed here include (i) requests to change a method of accounting and (ii) requests for extensions to file certain tax elections under Treas. Reg. § 301.9100-3.
- <sup>4</sup> Each year the IRS publishes a revenue procedure that explains the process for requesting a PLR. The most recent such revenue procedure is Rev. Proc. 2016-1, 2016-1 I.R.B. 1.
- <sup>5</sup> Each year the IRS publishes revenue procedures that list the "no rule" area for domestic and international issues. The most recent such revenue procedures are Rev. Proc. 2016-3, 2016-1 I.R.B. 126 (domestic) and Rev. Proc. 2016-7, 2016-7 I.R.B. 239 (international).
- <sup>6</sup> A taxpayer may however avoid a penalty for paying too little tax to the extent the taxpayer's position is based on a PLR, even if it was not issued to the taxpayer. Treas. Reg. § 1.6662-4(d)(3)(iii).
- <sup>7</sup> Each year the IRS publishes a revenue procedure that explains the process for requesting a TAM. The most recent such revenue procedure is Rev. Proc. 2016-2, 2016-1 I.R.B. 102.
- <sup>8</sup> TAMs may also be requested by the Appeals office within the IRS.
- <sup>9</sup> As with a PLR, a taxpayer may avoid penalties for paying too little tax if its position is based on a TAM issued to another taxpayer. Treas. Reg. § 1.6662-4(d)(3)(iii).

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# Possible Opportunities for Product Design: the IRS Advises on a Notice That Does *Not* Apply to Non-Qualified Annuities

By John T. Adney and Mark Griffin

**T**wo companion pieces of guidance published by the IRS last June may have created opportunities for life insurers to develop income options under non-qualified annuity contracts that provide flexibility for contract owners while also according section 72(b) “exclusion ratio” treatment to the income payments, concepts not previously viewed as coexisting peaceably.<sup>1</sup> Interestingly, this came about in official guidance that was issued to clarify that the tax treatment announced for certain qualified defined benefit plan distributions do *not* apply to non-qualified annuities.

In Notice 2016-39, the IRS and the Treasury Department provide guidance apparently directed at the Civil Service and Federal Employees Retirement Systems. The Notice advised on the treatment of payments made under a defined benefit plan during “phased retirement,” denying them treatment as “amounts received as an annuity” under section 72. Simultaneously, the IRS and Treasury released Revenue Procedure 2016-36 to provide assurance that the manner in which the terms

“annuity starting date” and “amounts received as an annuity” are applied in Notice 2016-39, which results in denial of annuitization treatment of the phased retirement payments, does not apply to non-qualified annuities. In doing so, the new revenue procedure also describes two product features that “generally will not affect the determination of whether payments are amounts received as an annuity” in the case of non-qualified annuities. In particular, the guidance in Rev. Proc. 2016-36 seems to allow periodic payments under non-qualified annuities to qualify for exclusion ratio treatment in circumstances where otherwise the payments would be characterized as “amounts *not* received as an annuity,” subject to taxation on an income-first basis.

While the exact meaning of the guidance in Rev. Proc. 2016-36 remains to be seen, understanding its teaching (and that of Notice 2016-39) as well as its possible implications requires some explanation.

## A BRIEF TUTORIAL ON SECTION 72 (IN RELEVANT PART)

An amount received under an annuity contract, whether the amount is paid under a non-qualified contract issued by an insurer or under an employer’s qualified defined benefit plan, is includible in gross income except to the extent that it represents a recovery of the “investment in the contract,” *i.e.*, generally the after-tax premiums or contributions under a contract or plan. The portion of the amount so received that is includible in gross income is determined differently depending on (1) whether the amount constitutes an “amount received as an annuity” or an “amount not received as an annuity” as those phrases are used in section 72, and (2) whether it is received before the “annuity starting date” or on or after that date.



*Amounts received as an annuity:* Treas. Reg. § 1.72-2(b)(2) provides that payments under an annuity contract are considered “amounts received as an annuity” only if they satisfy three conditions:

- 1 The amount must be received on or after the “annuity starting date.” Section 72(c)(4) defines the annuity starting date as “the first day of the first period for which an amount is received as an annuity under the contract.” Treas. Reg. § 1.72-4(b)(1) explains that the first day of the first period for which an amount is received as an annuity is the later of (1) the date upon which the obligations under the contract become “fixed,” and (2) the first day of the period (year, half-year, quarter, month or otherwise) which ends on the date of the first annuity payment.
- 2 The amount must be “payable in periodic installments at regular intervals (whether annually, semi-annually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date.”
- 3 Except in the case of variable payments, the total amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory. In the case of variable periodic payments, this third requirement is satisfied if the amounts are to be received for a “definite or determinable time,” whether for a period certain or for a life or lives.<sup>2</sup>

*Taxation of amounts received as an annuity:* If payments qualify as amounts received as an annuity, the manner in which the investment in the contract is recovered differs somewhat between a non-qualified annuity (or an IRA annuity) and a qualified employer retirement plan, including a defined benefit plan. In the case of a non-qualified annuity (or an IRA), section 72(b)(1) excludes from gross income an amount equal to the periodic payment multiplied by an exclusion ratio. The exclusion ratio is the ratio of the investment in the contract as of the annuity starting date (adjusted for the value of any refund feature) to the expected return under the contract. (The calculation for variable annuity payments is somewhat different but yields a similar result.) In the case of a qualified employer plan, on the other hand, section 72(d) provides that the investment in the contract is recovered using a “simplified method.” This simplified method excludes from income the portion of a monthly payment that does not exceed the amount obtained by dividing the investment in the contract as of the annuity starting date by the number of

In substance, Notice 2016-39 provides that a defined benefit plan participant who enters phased retirement (as defined in the Notice) and begins receiving a portion of his benefit payments will be taxed on those payments as “amounts not received as an annuity.”

anticipated payments determined under a table set out in section 72(d)(1)(B)(iii) or (iv).

*Partial annuitization:* Section 72(a)(2) provides a rule allowing the partial annuitization of a deferred annuity contract. (Although sometimes thought of as applicable only to non-qualified annuity contracts, in fact this provision is not limited to non-qualified contracts.) Under this rule, payments under a portion of an annuity contract for a period of 10 years or more, or for one or more lives, can qualify for treatment as “amounts received as an annuity.” Specifically, the statute treats the portion of the account value applied to the partial annuitization as a separate contract with its own annuity starting date and exclusion ratio, and it provides for a pro rata allocation of the investment in the contract between the annuitized and non-annuitized portions of the contract.

*Taxation of amounts not received as an annuity:* If payments do not qualify as “amounts received as an annuity”—*i.e.*, they are classified by section 72 as “amounts not received as an annuity”—there is a dramatic difference in the treatment of the payments as between qualified and non-qualified annuities. In the case of a non-qualified annuity, the payments are taxed on an income-first basis pursuant to section 72(e)(2) and (3), whereas section 72(e)(8) accords a more favorable pro rata recovery of investment in the contract to the payments when made from qualified retirement plans and IRAs, with the determination of the excludable amount made at the time of the distribution or at a time provided by the IRS. Hence, if periodic payments fail to qualify as amounts received as an annuity, the federal income tax impact is much more significant for non-qualified annuities than for qualified retirement plans and IRAs.

#### PHASED RETIREMENT GUIDANCE: NOTICE 2016-39

Notice 2016-39 addresses the taxation under section 72 of defined benefit plan payments made during phased retirement. The Notice defines phased retirement as “an arrangement under which a participant in a qualified defined benefit plan commences the distribution of a portion of his or her retirement benefits from the plan while continuing to work on a part-time basis.” From a financial perspective, the phased retirement arrangement described in the Notice is similar to the partial annuitization of a deferred annuity contract, *i.e.*, a portion of the employee’s retirement benefit begins to be paid in the form of regular periodic payments while the remainder of the benefit is deferred to a future date. Indeed, the similarity of the two seems to have prompted the further guidance that appeared in the form of the new revenue procedure, as noted below.

In substance, Notice 2016-39 provides that a defined benefit plan participant who enters phased retirement (as defined in the Notice) and begins receiving a portion of his benefit payments will be taxed on those payments as “amounts not received as an annuity.” As a result, the phased retirement payments will be subject to the pro rata recovery rules of section 72(e)(8), rather than the simplified exclusion ratio rules that apply to amounts received as an annuity under section 72(d). The Notice reaches this conclusion by reasoning that the plan’s obligations are not “fixed within the meaning of § 1.72-4(b)(1) during the participant’s continued part-time employment,” which is to say that the payments are not made after the annuity starting date. To this end, the Notice points to several aspects of the phased retirement arrangement, including the unknown duration of the phased retirement period (which is within the control of the employee), the accrual of additional benefits before the full benefits begin, and the indeterminate form of the phased retirement benefit.

The arrangement described in the Notice appears to parallel the phased retirement program that the Federal government introduced in 2014 for the Civil Service Retirement System and the Basic Benefit Plan of the Federal Employees Retirement System. The guidance might also apply to state and local government defined benefit plans and some church defined benefit plans with after-tax contributions, but not to most private sector plans (which are subject to the section 401(a)(11) qualified joint and survivor and preretirement survivor annuity requirements).

#### NON-QUALIFIED ANNUITY GUIDANCE: REV. PROC. 2016-36

While the IRS and Treasury thought it necessary to issue guidance on the treatment of payments received from qualified defined benefit plans during phased retirement, the precise rule addressed in Notice 2016-39—the application of section 72(e)(8) rather than section 72(d)—on its face has no bearing on

... Rev. Proc. 2016-36 might be read as potentially expanding the circumstances in which periodic payments from a non-qualified annuity can qualify as “amounts received as an annuity” . . .

the treatment of non-qualified annuities. So, what motivated the issuance of the companion revenue procedure, speaking to non-qualified products? It appears there were concerns within the government that taxpayers (and particularly life insurers) could view the conclusion of Notice 2016-39 (*i.e.*, that the initial stream of periodic payments are taxed as amounts not received as an annuity) and the reasoning behind that conclusion (*i.e.*, that until the employee’s full retirement benefit begins the plan’s obligations were not fixed) as producing an inappropriate result in the case of non-qualified annuities. For example, the analysis in the Notice might be viewed as inconsistent with the partial annuitization rules of section 72(a)(2). To avoid this possibility, the Notice expressly provides that it does not apply to amounts received from non-qualified contracts, and that Rev. Proc. 2016-36 “provides guidance regarding the application of Treas. Reg. §§ 1.72-2(b)(2) and 1.72-4(b)(1) to non-qualified contracts.”

Picking up where the Notice left off, Rev. Proc. 2016-36 begins by reciting the facts and conclusion of Notice 2016-39 and proceeds to discuss the differences between how annuity and non-annuity payments are taxed depending on whether they originate from a qualified plan or a non-qualified contract. Then, importantly, the revenue procedure states in section 3.06:

The Internal Revenue Service will not apply Notice 2016-39 to amounts received from a non-qualified contract. Accordingly, in applying §§ 1.72-2(b)(2) and 1.72-4(b)(1) to a non-qualified contract, the possibility of further contributions to the contract or a subsequent election under the contract to receive the benefit payable under the contract in a different manner generally will not affect the determination of whether payments are amounts received as an annuity.

The revenue procedure concludes (in section 4) that it applies to taxable years beginning on or after Jan. 1, 2016, while



expressly permitting taxpayers to apply it to taxable years beginning before that date.

Of potential interest to annuity taxpayers generally and annuity product designers in particular, section 3.06 of Rev. Proc. 2016-36 might be read as potentially expanding the circumstances in which periodic payments from a non-qualified annuity can qualify as “amounts received as an annuity” in two significant respects. First, that section seems to suggest that the ability of an annuitized contract’s owner to change to a different form of annuity benefit would not prevent the obligations under the contracts from becoming “fixed”—the first condition noted above for amounts received as an annuity—and thus would not affect the eligibility of the payments to receive exclusion ratio treatment. The law in this area has been uncertain, with some prior rulings involving non-qualified annuities suggesting that exclusion ratio treatment applied partly because the policyholder lacked such a right. *See, e.g.*, PLR 201424014 (March 10, 2014). On the other hand, Treas. Reg. § 1.72-11(e) describes the treatment under section 72 of a situation where “the terms of the contract are modified or the annuity obligations are exchanged” to provide a different payment term and states that a new exclusion ratio is calculated in such circumstances. The latter arguably contemplates that the modification can occur as a result of the contract owner having the right to make the change.

Second, section 3.06 indicates that the payment of additional premiums after a payment stream begins will not in itself impair the ability to receive exclusion ratio treatment for the payments. However, the section 72 regulations require that the investment in the contract used to calculate an exclusion ratio be determined as of the later of the annuity starting date or the date on which an amount is first received as an annuity. *See* Treas. Reg. § 1.72-6(a)(1). If an exclusion ratio is calculated using the investment in the contract at that time, but a subsequent premium can be paid, this leaves one wondering about the effect of the subsequent premium on the previously calculated ratio. More generally, the retention of the right to pay an additional premium (or change to a different form of annuity benefit) raises questions about what it means for the obligations under an annuity contract to be “fixed.” Although it is unclear, perhaps the partial annuitization rules can apply where additional premiums can be paid under the contract, with the payment stream being treated as a separate contract with a separate exclusion ratio, at least where the payment stream is made in accordance with those rules for a period of 10 years or more, or for one or more lives.

The guidance provided in the revenue procedure also could affect the application of section 72(s) in some circumstances. This section states that a contract will not be treated as an annuity contract for tax purposes unless it provides certain distribution requirements that apply after the death of any “holder”



of a non-qualified annuity contract. These after-death distribution requirements differ depending on whether the holder dies before the annuity starting date or thereafter. Hence, to the extent that the ability to pay additional premiums after periodic payments have commenced, or change the manner in which periodic payments are made, affects whether the payments constitute amounts received as an annuity on or after the annuity starting date, these features also will affect how section 72(s) applies to the contract.

#### A PARABLE AND A CONCLUSION

Some years ago, a taxpayer named Donna Elizabeth Conway brought a case in the Tax Court that challenged a long-held view by many in the IRS and the tax bar, *i.e.*, that one could not partially exchange an annuity contract and claim the benefit of tax-free treatment for the transaction under section 1035. The Tax Court disagreed with that long-held view and supported the taxpayer,<sup>3</sup> the IRS concluded that the Tax Court had a point, and thus began a series of revenue procedures explaining what would and would not qualify as a tax-free partial exchange.<sup>4</sup> So much for the conventional wisdom of the tax bar.

With publication of Rev. Proc. 2016-36, history may be repeating itself. The revenue procedure indicates that section 72(b) exclusion ratio treatment (*i.e.*, treatment of payments as amounts received as an annuity) may be available where the contract owner retains the right to alter the payments in mid-stream or to enhance the future payments via additional contributions after the

payments have begun. While the guidance in Rev. Proc. 2016-39 presents a few important operational questions and its exact meaning remains to be seen, it may overturn conventional wisdom and provide annuity owners and product designers with some welcome flexibility. ■

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#### ENDNOTES

<sup>1</sup> Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended.

<sup>2</sup> Treas. Reg. § 1.72-2(b)(3)(i).

<sup>3</sup> *Conway v. Comm'r*, 111 T.C. 350, 355 (1998), *acq. in result* 1999-2 C.B. xvi.

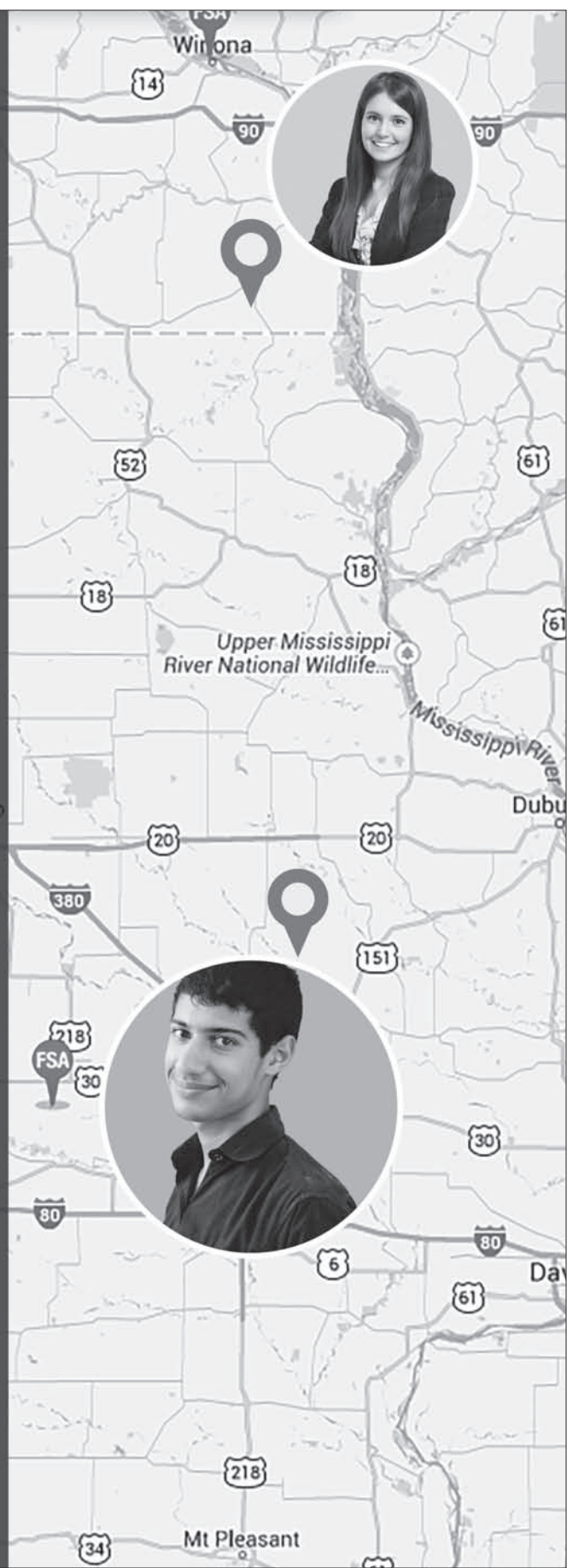
<sup>4</sup> *Action on dec.*, 1999-016 (Nov. 26, 1999); Rev. Proc. 2011-38, 2011-30 I.R.B. 66, modifying and superseding Rev. Proc. 2008-24, 2008-1 C.B. 684.

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# Significant LB&I Examination Developments

By Samuel A. Mitchell

Over the last year, the IRS's Large Business and International Division (LB&I) has reorganized and started to transition to a new way of examining large corporate taxpayers that it hopes will enable it to more efficiently resolve issues with its increasingly limited resources. The new approach—referred to as a “campaign” approach—has not been fully described or implemented yet, but it is apparent that is not just a reordering of procedures or reshuffling of boxes on an organization chart. Rather, it seems at this point to be a fundamental change of practice. LB&I is moving from a continuous general examination approach to an issue-focused approach under various “campaigns.” There will be many changes in practice. This piece is not intended to cover the entire scope of the changes, but just to highlight three general points that should be considered now. First, the campaign approach may present new opportunities to resolve industry issues on a global basis through Industry Issue Resolution (IIR) procedures similar to the successful insurance industry IIRs for bad debts and Variable Annuity hedging. Second, for those insurance company taxpayers that continue to be examined under the campaign approach, the administrative changes to the exam process will require more and earlier participation by tax departments and supporting actuaries and more and earlier cooperation with IRS examination teams. And third, it is apparent that not all insurance company taxpayers that have been examined in the past will continue to be examined under the campaign approach. This may seem like great news, but it presents some administrative complexities that should be considered and planned for now.

Just what is the campaign approach, and how will it affect insurance company taxpayers? As of the time of this writing,<sup>1</sup> LB&I has only described the overall approach and has not filled in many details, but the approach is part of an overall restructuring of the organization that is public and we at least know who is responsible for dealing with insurance issues and we have some idea of how issues for campaigns will be identified. In general, LB&I has been restructured into five subject-matter practice areas and four geographic practice areas.<sup>2</sup> The subject-matter practice areas are Pass-Through Entities, Enterprise Activities, Treaty and Transfer Pricing, Withholding and International Individual Compliance and Cross-Border Activities.<sup>3</sup> Each subject-matter practice area is led by a director, to whom other

directors and senior managers report. The geographic practice areas are Northeast, East, Central and West.<sup>4</sup> Similarly, the geographic practice areas are led by directors who have the titles director, Northeastern [Eastern, Central and Western respectively] Compliance Practice Area. The insurance industry is being handled by the Enterprise Activities Practice Area, which will also handle other financial institutions, financial products and corporate credits. The Enterprise Activities Practice Area is currently led by Director Kathy Robbins, who is located in Houston, Texas. The director who reports to Robbins and is responsible for insurance companies is Gloria Sullivan, who is located in Oakland, California. A senior manager covering insurance, banking and finance will report to Sullivan. The senior manager is Deborah Inganamorte (program manager, Insurance, Banking and Financial Institutions), located in New York City. It appears that Inganamorte will be the point person for insurance issues.

LB&I has not described how they are identifying issues and creating campaigns, but the general idea is described in an internal memorandum entitled “FY2016 Focus Guide,” from the LB&I Commissioner, Douglas O'Donnell, to LB&I staff, published in January 2016. In the memorandum to employees, Commissioner O'Donnell describes the campaign approach as follows:

We plan to use the combined input of our workforce and data analysis to identify areas of noncompliance and strategically focus resources to these areas. Campaigns are intended to:

- Identify specific areas of potential noncompliance,
- Identify intended compliance outcomes,
- Identify specific, tailored treatment streams to achieve those outcomes,
- Identify the resources needed to execute these tailored treatment streams,
- Identify training, guidance, mentors, and other support needed, and
- Effectively use feedback from employees to quickly modify our approach as needed.

The commissioner's descriptive bullet points for the campaign approach are difficult to interpret without inside knowledge or further explanation that so far has not been forthcoming. However, it seems apparent that personnel with subject-matter expertise in the practice areas described above will identify compliance issues and collaborate with others in the organization to pursue the issues in the particular industry and promote



compliance. At one point, there was some discussion of a type of hub-and-spoke system in which examiners would focus on select taxpayers in an industry, identify issues, and then leverage that experience into more limited scope examinations of other industry taxpayers that may have the same issues—this may be one type of “treatment stream” referenced in the commissioner’s comments.

#### INCREASED POTENTIAL FOR GLOBAL RESOLUTIONS

The issue identification and development for “treatment streams” probably will allow for a flexible approach that will encompass a number of different issue-identification methods and implementation processes. As of the time of this writing, LB&I has announced the formation of three campaigns, which include one insurance campaign.<sup>5</sup> The insurance campaign is focused on captive insurance, and this topic likely emerged as a campaign because it is on the guidance plan and has been the subject of significant recent litigation.<sup>6</sup> This flexibility in the “campaign” issue identification and “treatment stream” approach may present opportunities for insurance company taxpayers and other taxpayers to resolve more issues with LB&I on a global basis. For example, industry participants could submit Industry Issue Resolution (IIR) requests under the process described in Rev. Proc. 2016-19, 2016-13 I.R.B. 497, similar to successful efforts in the recent past for insurance company bad debts and variable annuity hedging, which resulted in safe harbor approaches described in LB&I Commissioner Directives. The IIR process is not an examination process *per se*, but a global resolution “treatment

stream” is consistent with the resource-saving rationale that underlies the campaign approach as described so far. An LB&I official said as much in a conference earlier this year, noting that the campaign approach might not always involve an examination and may include such things as soft letters or IIRs.<sup>7</sup> Insurance company taxpayers should be encouraged by this possibility, and particularly so in light of the significant examination efficiencies companies and LB&I have achieved in the two recent insurance industry IIRs involving bad debts and variable annuity hedging.

#### PROCEDURAL CHANGES THAT WILL AFFECT WORK-FLOW

Along with the new and developing methods for selecting issues for examination and enforcement, LB&I has changed its procedures for the taxpayers that will be examined. These changes were explained for the most part in IRS Publication 5125, which was finalized in February 2016, and have since been incorporated in the Internal Revenue Manual (I.R.M.).<sup>8</sup> In general, Publication 5125 explains that an examination will have three phases, which are a planning phase, an execution phase and a resolution phase. The phased approach is not all that different from prior procedures, but some of the details encompass significant changes in procedure that will affect the work-flow of tax departments and supporting actuaries. The two most significant procedural changes that will result in work-flow changes pertain to informal refund claims and the fact gathering procedures that agents must follow before sending un-agreed issues to IRS Appeals.

Regarding refund claims, the new procedures explained in Publication 5125 provide that taxpayers should bring informal claims to the attention of the examination team as soon as the taxpayer becomes aware of any potential claim for refund. The publication furthermore explains that LB&I will only accept informal claims that are asserted within 30 calendar days of the opening conference. Claims raised after the 30-day mark must be submitted on amended tax returns (*i.e.*, a Form 1120X) that are filed under normal refund claim procedures unless the issue is identified for examination or unless the taxpayer can convince LB&I senior management to grant an exception. The amended returns will be subject to the procedures for evaluating examination resources and may or may not be included in the current examination. Although this change is intended to result in resource efficiencies, it is a significant departure from past practice that may actually have an adverse effect on efficiency for both LB&I and taxpayers. In the past, taxpayers answering Information Document Requests (IDRs) or just simply reviewing the tax return filings would find and routinely assert affirmative claims that were not necessarily related to the issues under examination but nevertheless were discovered in the process of dealing with those issues. The new requirement to file amended returns for such issues will just delay the ultimate resolution of each examination cycle and may cause further delays after an appeal.

If an issue has to be filed on an amended return, it may be in the taxpayer's best procedural interest to file it at the end of the IRS's assessment statute in order to close the assessment statute as soon as possible and to minimize the expenses involved in corollary state filings. This means that taxpayers may have the incentive to file latent claims—that they did not discover early on—very late in the process, after a cycle has gone through an administrative appeal and the IRS's assessment statute has closed. The Internal Revenue Code allows taxpayers a period of six months after the IRS's assessment statute closes to file a refund claim if the assessment statute has been extended past its normal date,<sup>9</sup> and virtually all examinations result in extended statutes. In view of these potential delays, LB&I likely will adopt a common-sense approach to dealing with claims that taxpayers discover after the 30-day mark, particularly when it is evident from the surrounding circumstances that the taxpayer is not attempting to game the system. However, because the new rules literally require amended returns for late-discovered issues, it will be in the taxpayer's best interest to be more proactive in finding and asserting issues before the opening conference and

However, because the new rules literally require amended returns for late-discovered issues, it will be in the taxpayer's best interest to be more proactive in finding and asserting issues before the opening conference and the 30-day period begins.

the 30-day period begins. This obviously will accelerate the workflow of tax departments and the supporting actuaries.

The other procedural change that may accelerate workflow pertains to the facts that are forwarded to the IRS Appeals Division on unagreed issues. Publication 5125 explains that the examination team is required during the execution phase of the examination to attempt to procure a written acknowledgement in an IDR of all the relevant facts before issuing a Notice of Proposed Adjustment to the taxpayer. The fact-acknowledgement IDR process is intended to conform the exam procedures with the new Appeals Division approach, known as Appeals Judicial Approach and Culture (AJAC), under which the Appeals Division will refer a case back to the Examination Division if either the examination

division or the taxpayer attempts to introduce new facts into the appeal that were not considered during the examination. The I.R.M. was recently updated in order to incorporate procedures for the fact-acknowledgement process. I.R.M. Exhibit 4.46.4-3 provides a pattern IDR for the acknowledgement. Under the pattern request, the examination team provides the pattern IDR that incorporates a pro-forma Form 886-A that contains a fact statement and a statement of the exam team's proposed position and adjustment. The pattern IDR seeks a check-box type of acknowledgement with respect to the fact statement in the Form 886-A that (1) the facts are accurately stated; (2) the taxpayer is providing additional facts and supporting documents; or (3) the taxpayer is identifying disputed facts and provides additional clarification and/or documentation.

It is difficult at this stage to know exactly how taxpayers should respond to the fact-acknowledgement IDRs because, at least so far, the fact statements appear to differ little from the fact statements in revenue agents' reports that have been sent to the Appeals Division under prior procedures. It is only natural for an exam team drafting facts to draft the facts in a way that is spun in favor of the team's position. This places taxpayers in a difficult position. So far, the best approach in response to these IDRs appears to be to provide a written response in which the taxpayer (1) points out obvious errors, (2) reserves the right for further objections, (3) incorporates by reference the information that has been provided during the examination, and (4) provides any additional information and documents that were not covered by the earlier issued IDRs. Taxpayers have some flexibility in the level of response to fact-acknowledgement IDRs because the I.R.M. clarifies that the IDRs are not subject to the summons enforcement and other strict procedures that apply to other IDRs.<sup>10</sup> However, because of the Appeals Division AJACs approach regarding new facts, it is critically important to provide any relevant facts and documents that the examination team perhaps should have asked for but did not in the IDR process. Although this will accelerate the work-flow of the tax department and actuaries, it will save time and resources for both the taxpayer and LB&I in the long run as they go through the administrative appeal process.

## REDUCTION IN EXAMINATIONS

Whatever final form the new campaign approach takes, it is important to understand that the process is inconsistent with the Coordinated Industry Case (CIC) examination process that large life insurance companies have grown accustomed to over the years.<sup>11</sup> CIC taxpayers have essentially experienced continuous examinations under two-year examination cycles. Under the campaign approach, many CIC taxpayers may not be examined as regularly or at all in the future unless they encounter an IRS "campaign" as the CIC procedures are phased out. As mentioned above, fewer examinations may seem like great news, but

there are procedural problems that may make things even more complicated for taxpayers that are used to a continuous examination process. The most significant problem relates to the correction of mistakes on the filed returns. There are no tax returns that are any more complex than a large life-nonlife consolidated tax return and inevitably mistakes occur. Revenue Procedure 94-69, 1994-2 C.B. 804, permits CIC taxpayers to avoid negligence and substantial understatement penalties with respect to mistakes and other items on the examined returns through filing written statements (Qualified Amended Returns, or QARs) during the examination. It has been routine for taxpayers to correct items like reserve errors through this process. At this point, the only clearly defined method for taxpayers that no longer have the Rev. Proc. 94-69 QAR process to correct mistakes will be to file amended tax returns, which is a labor intensive process that involves corollary state filing obligations. Taxpayers that have been notified that years may be skipped for examination or that they are not going to be examined should open discussion now with LB&I regarding how to deal with potential QARs on the skipped years.

## CONCLUDING THOUGHTS

Over the last few years as the IRS's overall budget has been constrained it has become apparent that LB&I has had to struggle and innovate to keep up with its enforcement mission in the large business and international segment. Thus far, LB&I has done an admirable job of making procedural changes, such as the IDR procedures released in 2013 and 2014 that are designed to make the examination process more efficient,<sup>12</sup> and cooperating with taxpayers through such mechanisms as the Industry Issue Resolution process to resolve significant issues in a resource-sensitive way. The new campaign approach appears to be a natural step in this movement toward more efficiency, although it will present some administrative filing difficulties and may create some additional burdens. As the process is rolled out and completed, insurance company taxpayers would be wise to seek opportunities

to take advantage of additional possible global resolutions and be cognizant of the potential procedural problems that may arise. ■

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## ENDNOTES

- <sup>1</sup> July 2016.
- <sup>2</sup> See the LB&I Division Directory, available at <https://www.irs.gov/businesses/large-business-and-international-lb-i-division-directory>, referenced here as of July 2016.
- <sup>3</sup> *Id.*
- <sup>4</sup> *Id.*
- <sup>5</sup> Comments of Cheryl Teifer, Director, Field Operations Transfer Pricing Practice Area, at a tax conference, as reported in Stephanie Soong Johnston, "New IRS LB&I Campaigns Approved With More Under Evaluation," Tax Analysts Highlights & Documents, June 10, 2016, at 5273.
- <sup>6</sup> See, e.g., *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1 (2014), *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225; see also Office of Tax Policy and Internal Revenue Service 2015-2016 Priority Guidance Plan.
- <sup>7</sup> Comments of Thomas Kane, LB&I Division Counsel, at a tax conference, as reported in Amy S. Elliott, "LB&I's First Audit Campaigns to Be Announced Soon," Tax Analysts Highlights & Documents, June 9, 2016 at 5200.
- <sup>8</sup> See generally I.R.M. section 4.46.4 Executing the Examination.
- <sup>9</sup> I.R.C. § 6511(c)(1).
- <sup>10</sup> See I.R.M. section 4.46.4.9.3.
- <sup>11</sup> The campaign approach also may have implications for the future of the Compliance Assurance Process (CAP) program for large taxpayers under which the taxpayer and the examination team collaborate on potential issues during the return filing process. The CAP program consumes LB&I resources and may be in jeopardy.
- <sup>12</sup> See LB&I 04-0214-004 (Feb. 28, 2014); LB&I 04-1113-009 (Nov. 4, 2013); and LB&I 04-0613-004 (June 18, 2013).

# Taxation Section Webcast: “Federal Income Tax Issues Every Company Must Consider under Life PBR”

By Kristin R. Norberg, Mark S. Smith, and Peter H. Winslow

**O**n June 10, 2016, the Taxation Section hosted a webcast entitled “Federal Income Tax Issues Every Company Must Consider under Life PBR.” Panelists Kristin R. Norberg, Mark S. Smith, and Peter H. Winslow led the audience through an exploration of the many potential tax issues and areas of interpretation that will arise once principle-based reserves (PBR) becomes the new statutory financial reporting regime for life insurance contracts.

The webcast had a great turn-out, with approximately 120 sites registered and well over 900 participants. Three-quarters of respondents to the polling questions identified as actuaries who are not primarily focused on tax. This was by far the largest audience the Taxation Section has attracted for a webcast, which is indicative of the importance of this topic as the industry marches ever closer to the operative date for Life PBR.

After a brief update on the state adoption status and an introduction to past guidance from the Internal Revenue Service (IRS), the panelists explored topics in the following categories:

- **Policyholder tax compliance**—relating to the concurrent adoption of the 2017 Commissioners’ Standard Ordinary Mortality Tables.
- **Transition rules**—including the initial three-year transition, the small company and single-state exemptions, and issues for companies domiciled in states that have not yet adopted PBR.
- **The three components of PBR**—the net premium, deterministic, and stochastic reserve components, addressing the inclusion of each component in the federally prescribed reserve and the statutory cap, as well as approaches for meeting the interest and mortality requirements and the other computational rules of Internal Revenue Code section 807(d).



Within each category of topics, the panelists first explained the relevant requirements in the NAIC’s Valuation Manual, the rules in the Internal Revenue Code, and any available guidance from the IRS, then continued with an open discussion of the interpretational challenges and potential ways to approach each tax compliance issue. Additionally, the panelists provided a reference to the many informative articles and dialogues that have been published in *TAXING TIMES* throughout the newsletter’s history (see sidebar).

## CONTINUING PBR ADOPTION ACTIVITY

Later on the day of the webcast, the NAIC Joint Executive (EX) Committee and Plenary approved the recommendation of the Principle-Based Reserving Implementation (EX) Task Force that the legislation enacted in 45 states met the “substantially similar terms and provisions” threshold in the Standard Valuation Law, leading to an operative date of Jan. 1, 2017. At the date of this writing, 46 states, representing over 85 percent of relevant industry premium, had enacted a new version of the Standard Valuation Law to enable PBR, and legislation is progressing through the Massachusetts legislature. Additionally, the New York Department of Financial Services (DFS) Superintendent Maria T. Vullo announced on



July 6, 2016 that the DFS would adopt PBR, likely with some New York-specific guidelines and safeguards, beginning January 2018.<sup>1</sup> The future of life insurance reserving is here, and it is incumbent on the actuarial and tax professionals in insurance companies to work together to be ready to comply with the new regime for tax purposes as well as for statutory financial reporting. We hope this webcast helped companies along this journey by identifying key issues where each company will need to develop and document its tax interpretations.

**If you missed the webcast, you can purchase a recording on the SOA website, <https://www.soa.org/professional-development/archive/webcast-recordings.aspx>. ■**

#### ENDNOTES

<sup>1</sup> <http://www.dfs.ny.gov/about/press/pr1607061.htm> (accessed 8/5/2016).

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Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally-Prescribed Reserves," 21 *TAXING TIMES*, Vol. 12, Issue 1 (March 2016)

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# ACLI Update

By Pete Bautz, Mandana Parsazad and Regina Rose

## HOUSE TAX REFORM BLUEPRINT

**O**n June 24, House Republicans released their tax reform blueprint (the Blueprint), the final piece of a multi-part plan designed to set the House Republicans' policy agenda before the party's national convention in July. The 35-page document calls for an across-the-board reduction in tax rates, including a corporate tax rate of 20 percent, a pass-through tax rate of 25 percent and a top individual tax rate of 33 percent (with two lower individual tax brackets of 12 and 25 percent). On the domestic side, the plan introduces consumption-like tax features into the Internal Revenue Code (the Code). Businesses will be allowed 100 percent expensing of both tangible and intangible assets (except for land), but will no longer be able to deduct interest expense in excess of interest income. Any nondeductible net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years. This is similar to provisions in the American Business Competitiveness Act sponsored by Rep. Devin Nunes (R-CA), a senior House Ways & Means Committee (W&M) member. Corporations will still be able to claim research credits. Net operating losses (NOLs) can be carried forward indefinitely but will be limited to ninety percent of net taxable income for any year without regard to the carryforward. NOL carryforwards will be inflation-adjusted. Carrybacks of NOLs will no longer be permitted. The Blueprint eliminates special interest deductions (mostly unspecified) such as the Section 199 deduction for domestic production. In addition, the corporate alternative minimum tax (AMT) will be eliminated.

The plan calls for a territorial rather than the current worldwide system of taxation for international profits, including a 100 percent exemption for dividends from foreign subsidiaries. The Blueprint contains a border adjustability provision that exempts exports and taxes imports. Accumulated foreign earnings will be deemed repatriated and taxed at 8.75 percent to the extent held in cash or cash equivalents, and otherwise taxed at 3.5 percent (with companies allowed to pay this tax over an eight-year period). The Subpart F rules for controlled foreign corporations will be significantly streamlined and simplified to focus on counteracting shifts of truly passive income to low-tax jurisdictions.

On the individual side, both the individual AMT and the estate tax will be eliminated and there will be a 50 percent exclusion for capital gains, dividends and interest income. Personal

exemptions and standard deductions, along with the child tax credit, will be consolidated into a larger standard deduction and an enhanced child and dependent tax credit aimed at reducing the number of taxpayers who itemize deductions from one-third to approximately 5 percent. All itemized deductions except the deductions for mortgage interest and charitable contributions are eliminated.

All taxes that were part of the Affordable Care Act, including the 3.8 percent net investment income tax, the additional .9 percent payroll tax, the medical device tax, and the health insurance tax would be repealed as part of the Health Care Task Force Blueprint that was released in late June. The exclusion for employer-provided health insurance and related health provisions are maintained as part of the Health Care Task Force Blueprint; however, the health blueprint imposes undefined caps on the employer-provided health insurance exclusion.

There is little detail in the Blueprint with respect to our industry. The Blueprint continues tax incentives for retirement savings. However, the Blueprint instructs W&M to work toward the creation of more general savings vehicles and to attempt to "consolidate and reform the multiple different retirement savings provisions in the current tax code to provide effective and efficient incentives for savings and investment." The Blueprint also notes that W&M will "work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models."

W&M has been tasked by House Speaker Paul Ryan (R-WI) and W&M Chairman Kevin Brady (R-Texas) with developing legislative language that details the high level concepts contained in the Blueprint. W&M staff intends to work with U.S. businesses as it goes about this work, and ACLI met with W&M staff in late July and plans to engage with staff as it considers industry-specific issues over the course of the next few months. Much of the work we have previously done regarding tax reform will help inform how we approach the details of the Blueprint. Both Speaker Ryan and Chairman Brady want the additional work on the Blueprint to be completed by January 2017.

## NEW TREASURY PROPOSED DEBT-EQUITY REGULATIONS

On April 4, Treasury/IRS released proposed section 385 debt/equity regulations that were designed to combat the earnings stripping benefits of cross-border indebtedness. The proposed rules would (i) impose on large taxpayer groups burdensome contemporaneous documentation requirements that must be satisfied for certain related party debt to be respected for federal income tax purposes; (ii) treat certain related party debt as stock

... the proposed debt-equity rules are overly broad and, if adopted in their present form, would significantly impact many ordinary business transactions and restructurings of even purely domestic corporations.

for all purposes of the Internal Revenue Code when issued in connection with certain distributions and acquisitions; and (iii) authorize IRS to broadly treat certain related party debt as part equity and part debt for federal income tax purposes. Unfortunately, the proposed debt-equity rules are overly broad and, if adopted in their present form, would significantly impact many ordinary business transactions and restructurings of even purely domestic corporations. Moreover, our members have expressed serious concerns that certain aspects of the proposed regulations would have particularly adverse impacts on life insurers. On June 17, ACLI submitted a comment letter to Treasury/IRS addressing our concern that the life/nonlife rules create additional detriment for life insurers since they—unlike companies in other industries—cannot fully consolidate with domestic affiliates in certain circumstances and therefore would not be able to fully avail themselves of the “consolidation” exception provided under the proposed Section 385 regulations. A second ACLI comment letter, which addresses issues under the proposed rules for certain common life insurance arrangements (including surplus notes and funds withheld reinsurance), was filed with Treasury/IRS on the July 7 comment due date.

ACLI staff and member company representatives met with Treasury in late June to discuss these concerns. Following the Treasury meeting, ACLI staff and member company representatives had numerous meetings with staff of the Congressional tax-writing committees to share the concerns noted above. Meanwhile, a bipartisan and bicameral cross-section of lawmakers has been sharing with Treasury their high-level concerns about the proposed rules. In fact, the Joint Committee on Taxation held a briefing on the proposed regulations in early July with two top Treasury officials, Mark Mazur, Treasury assistant secretary for tax policy, and Robert Stack, Treasury deputy assistant secretary (international tax affairs). At a three-hour-long IRS hearing on July 14, many of the 16 speakers raised very significant concerns about the proposed rules. Following that hearing, government officials reiterated their intention to consider all comments, but push to finalize these rules promptly.

## SENATOR WYDEN’S DERIVATIVE TAX PROPOSAL

Draft legislation released on May 18 by Senate Finance Committee ranking member Ron Wyden (D-OR) would mark derivatives to market for tax purposes. In addition to taxing derivatives as if they had been sold and repurchased at the end of each year, the draft legislation—the Modernization of Derivatives Tax Act, or MODA—would require ordinary tax treatment of resulting gains and losses and establish a source rule based on a taxpayer’s country of residence.

For insurers, a key component of MODA is the definition of “derivatives.” Specifically, the bill would include exceptions from the definition of derivatives for, among other things, business hedging and for insurance, annuity or endowment contracts. In addition, the bill would modify the definition of capital asset under section 1221(a) of the Code to exclude “any bond, debenture, note, or certificate or other evidence of indebtedness held by an applicable insurance company.” Taken together, these changes would mean that (i) insurance products would continue to be taxed under the provisions in the tax code that specifically address those products, and (ii) insurance company hedges relating to bonds and other evidences of indebtedness would qualify as hedging transactions under section 1221(b) of the Code and not as derivatives subject to the mark-to-market and related rules.

According to an estimate by the Joint Committee on Taxation, Senator Wyden’s proposal would raise \$16.5 billion over 10 years. Senator Wyden has requested comments on the draft legislation within 90 days of its May 18 release. ACLI is working with its member companies to analyze and comment on the proposal. ■

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# T<sup>3</sup>: TAXING TIMES Tidbits

## IRS Notice Helps Government Money Market Funds Satisfy Diversification Rules

By John T. Adney and Bryan W. Keene

In 1989, the IRS and the Treasury Department issued final regulations under section 817(h),<sup>1</sup> prescribing minimum standards for diversification of the investments of insurers' separate accounts supporting nonqualified variable life insurance and annuity contracts. The purpose of both the statute and the implementing regulations, according to the legislative history of the enactment, essentially was to bolster the "investor control" doctrine that the IRS had articulated in a series of revenue rulings.<sup>2</sup> While these regulations generally have stood the test of time, discrete changes have been made in them over the years,<sup>3</sup> and another such change was described in an IRS Notice issued last May. In Notice 2016-32,<sup>4</sup> the IRS announced that insurers' separate accounts or sub-accounts (technically, segregated asset accounts) that qualify as government money market funds (government MMFs) under SEC rules do not need to satisfy the diversification requirements in the section 817(h) regulations, as long as no policyholder has investor control over the account. More specifically, the Notice said that the regulations would be amended at some future date, but that pending such action, taxpayers could make use of the new, more favorable treatment for government MMFs by relying on the Notice itself. The Notice thus represents a quick and constructive reaction by the IRS to a change in the investment landscape affecting life insurers' variable products, demonstrating an IRS willingness to step in and help when relief is needed and warranted.

### BACKGROUND

What prompted such a liberalization? It turns out that the source of the IRS action was a step taken by a companion government agency, the Securities and Exchange Commission (SEC). By way of background, in July 2014 the SEC adopted new regulations regarding money market mutual funds, requiring such funds to provide a floating net asset value (NAV) and to impose "fees and gates" in some circumstances.<sup>5</sup> Importantly, these new requirements do not apply to a government MME, defined as a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, or fully collateralized repurchase

agreements. Not surprisingly, it is anticipated that the number of government MMFs will increase, perhaps substantially, thereby increasing demand for the types of government securities in which such funds invest. As the Notice gently puts it, "some MMFs are expected to convert to government MMFs, resulting in increased demand for government securities."

Variable life insurance and annuity contracts, of course, may be based on segregated asset accounts that either invest in money market funds or are themselves money market funds. In view of the SEC rule change, government MMFs may be preferable to the non-governmental variety as funding media for variable products, avoiding a floating NAV and side-stepping the possible difficulties of establishing fees and gates for money market funds supporting such products. That said, it is necessary for the separate account or sub-account supporting these products to comply with the section 817(h) regulations. Under those regulations, a segregated asset account must hold at least five investments in accordance with specified concentration limits, *e.g.*, no more than 55 percent of the value of the assets can be represented by a single investment. For purposes of those limits, moreover, all securities of the same issuer are treated as a single investment, although in the case of government securities section 817(h) itself treats each government agency or instrumentality as a separate issuer. Thus, for a segregated asset account that intends to invest solely in government securities, there must be securities of at least five government agencies or instrumentalities available in the financial markets.

The juxtaposition of the investment diversification requirements imposed by the section 817(h) regulations against the attractiveness of using government MMFs as the funding media for variable products posed a challenge. Given the anticipated increase in demand for government securities that are appropriate investments for money market funds and the relatively small number of government agencies that currently issue such securities, insurers issuing variable products and mutual fund companies providing the products' funding media were concerned that it may become difficult for an insurance-dedicated government MMF to satisfy the section 817(h) requirements in the future. To alleviate this situation, representatives of the life insurance industry and the mutual fund industry approached the IRS, requesting guidance that would provide special relief from the section 817(h) requirements for insurance-dedicated government MMFs.

### THE NOTICE

Happily, the IRS responded to the joint industries' request by issuing Notice 2016-32, announcing that the Treasury Department and the IRS intend to amend the section 817(h) regulations because "variable contracts should be able to offer government MMFs as an investment option." Even more helpful, the Notice

went on to state that “[p]ending the promulgation and effective date of future administrative or regulatory guidance,” taxpayers can rely on an “alternative” diversification test set forth in the Notice. According to this alternative test, a segregated asset account will be treated as adequately diversified for purposes of section 817(h) if (1) no policyholder has investor control, and (2) either (a) the segregated asset account itself is a government MMF under the applicable SEC rules or (b) the segregated asset account invests all of its assets in an insurance-dedicated “investment company, partnership, or trust” as defined in Treas. Reg. section 1.817-5(f)(1) that qualifies as a government MMF under the SEC’s rules.

The Notice’s requirement that no policyholder has “investor control” is a reference to the investor control doctrine that is described in the IRS’s rulings and that motivated the enactment of section 817(h) in the first place. The investor control doctrine holds that the owner of a variable contract is the taxpayer on the income and gains of the underlying separate account’s assets if the contract owner directly or indirectly controls the investment decisions with respect to those assets. The investment diversification requirements imposed by the section 817(h) regulations are premised on the notion that any such control is defeated, or at least materially dampened, where the separate account (or sub-account) must invest in a multiplicity of assets from different issuers.<sup>6</sup>

In particular, the diversification requirements rendered it impossible for a variable contract to be based on a single, publicly available mutual fund, which was the point of the IRS’s ruling, Rev. Rul. 81-225, that Congress effectively blessed in the section 817(h) enactment. But as the preamble to the regulations made explicit, the diversification requirements do not fully occupy the investor control field. The doctrine of investor control remains alive and well separately from the regulations, a proposition the IRS has asserted in a number of rulings and that the Tax Court seconded in a recent decision of note.<sup>7</sup> In issuing the Notice, the

IRS apparently wanted to clarify that while it was not concerned with having multiple government agency issuers, adherence to the investor control doctrine remained essential.

Presumably, however, the mere fact that a government MMF holds fewer assets than the regulations currently require (including, perhaps, holding only a single asset) will not, by itself, violate the investor control doctrine in the case of a government MMF, because otherwise the Notice’s intended relief would be defeated. Thus, the Notice’s proviso that “[n]o policyholder has investor control” was likely intended to mean no actual, direct control over the government MMF’s investment activity, rather than the type of indirect control addressed in Rev. Rul. 81-225 that arises when a segregated asset account is based on a single investment. In other words, investment discretion for a government MMF must remain in the hands of the fund’s investment manager rather than the policyholder in order for the Notice to apply.

Notice 2016-32 also referred to a segregated asset account that “itself is a government MMF” and to a segregated asset account that “invests all of its assets in an insurance-dedicated ‘investment company, partnership, or trust’” that qualifies as a government MMF. The first of these references is directed at so-called “managed account” structures, such as where a sub-account of the insurer’s separate account invests directly in individual government securities and the account qualifies as a government MMF under the SEC’s rules. The second reference is directed at the prevalent structure in the retail variable insurance market, where a sub-account of the insurer’s separate account invests in a single insurance-dedicated regulated investment company that, in turn, qualifies as a government MMF.<sup>8</sup>

#### THE EXTENT OF RELIEF, WITH A CONCLUDING THOUGHT

While the Notice thus represents a significant and helpful step forward, it is important to note the limits of the alternative rule

it announces. The new rule does not extend to so-called fund-of-funds structures, where a sub-account invests in an insurance-dedicated fund that, in turn, invests in a portfolio of lower-tier funds that includes an insurance-dedicated government MMF. In addition, the new rule does not extend to segregated asset accounts in which an insurance-dedicated government MMF is only one of several investments the account holds. Hopefully these limitations will not pose a problem, since these types of structures involve multiple investments in addition to government MMFs. Hence, the investment manager likely would be able to manage the assets in a way that would comply with the existing section 817(h) diversification requirements.

Regardless of any such limits on the reach of the Notice's relief, the existence of the Notice demonstrates the IRS's willingness to steer a practical course and react constructively to changes in the investment landscape affecting life insurers' variable products. Thus, when one contemplates "whence cometh our help," one typically does not look first to the IRS, but where relief is warranted, the Notice shows that the IRS should not be overlooked. ■

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## ENDNOTES

- <sup>1</sup> Unless otherwise indicated, references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the Code). The regulations appear as Treas. Reg. section 1.817-5, promulgated in T.D. 8242, 1989-1 C.B. 215.
- <sup>2</sup> See Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 211(a) (1984) (adding section 817(h) to the Code); H.R. Conf. Rep. No. 98-861, at 1055 (1984) (providing legislative history on the purpose of section 817(h)). The investor control doctrine is addressed in Rev. Rul. 2003-92, 2003-2 C.B. 350, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 81-225, 1981-2 C.B. 12, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468, and Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; and Rev. Rul. 77-85, 1977-1 C.B. 12. See also *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015); *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984).
- <sup>3</sup> See T.D. 9185, 2005-1 C.B. 749 (revoking former Treas. Reg. section 1.817-5(f)(2)(ii) regarding look-through treatment for "nonregistered" partnerships); T.D. 9385, 2008-1 C.B. 735 (amending the regulations to address the remedy for inadvertent failures to comply with the diversification requirements and to expand the list of "permitted investors" under the look-through rules of Treas. Reg. section 1.817-5(f)(3)).
- <sup>4</sup> 2016-21 I.R.B. 878.
- <sup>5</sup> See SEC Release No. 33-9616, IA-3879, IC-31166, Money Market Fund Reform; Amendments to Form PF, July 23, 2014.
- <sup>6</sup> See H.R. Conf. Rep. No. 98-861, at 1055 (1984) (stating that Congress intended the section 817(h) regulations to be "designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment would be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (e.g., stocks, bonds, or certificates of deposits of a single issuer); [or] (2) that invest in one or a relatively small number of publicly available mutual funds...").
- <sup>7</sup> See, e.g., Rev. Rul. 2003-92, 2003-2 C.B. 350, clarified and amplified by Rev. Rul. 2007-7, 2007-1 C.B. 468. See also *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015).
- <sup>8</sup> "Insurance-dedicated" means that, except as otherwise permitted in the regulations, (1) all beneficial interests in the regulated investment company are held by segregated asset accounts of insurance companies and (2) public access to the regulated investment company is available exclusively through the purchase of a variable contract. See Treas. Reg. section 1.817-5(f)(2)(i). Being insurance-dedicated allows the segregated asset account to "look through" the regulated investment company when applying the diversification test, rather than applying the test by treating the interest in the regulated investment company itself as a single asset of the account. See Treas. Reg. section 1.817-5(f)(1).

# Partial Annuitization Using a Deferred Income Annuity Rider

By Bryan W. Keene and Patrick C. Tricker

In May, the Internal Revenue Service issued PLR 201632004,<sup>1</sup> which addresses the partial annuitization rules of section 72(a)(2) in the context of a deferred income annuity rider (the Rider).<sup>2</sup> The ruling is interesting in several respects. It is the first private letter ruling (PLR) to address section 72(a)(2) since Congress added those rules to the Code in 2010. It also is the first PLR to address the tax treatment of a deferred income annuity (DIA) rider that is issued with a deferred annuity contract. In doing so, the ruling favorably resolves an inherent circularity in the statutory language of section 72(a)(2). The ruling also favorably answers a variety of questions that are somewhat peculiar to the use of a DIA payout in a partial annuitization. The peculiarities arise because of two key characteristics of a DIA payout, namely, a potentially long delay between the irrevocable election of the payout option and the date the payments actually commence, and the lack of any cash value during that time period.

## THE FACTS OF PLR 201632004

The taxpayer in PLR 201632004 is a life insurance company that intends to issue a non-qualified deferred variable annuity contract (the Contract) with the Rider.<sup>3</sup> During the accumulation period, the Contract provides various investment options, and the Accumulation Value and death benefit are based on the values held under those options. The owner can surrender the Contract or take withdrawals from the Accumulation Value, or apply the Accumulation Value to a payout option under the Contract.

The Rider will amend the Contract to provide the owner a DIA payout option. The payout option works like a typical DIA. That is, it provides life-contingent fixed annuity payments (the DIA Payments) that will commence on a specified date that is potentially several years in the future, with no withdrawal value or surrender right. The owner elects the DIA payout option by making one or more transfers of Accumulation Value from the Contract to the Rider. Each transfer entitles the owner to DIA Payments that are calculated at the time of the transfer using the company's then-current annuity purchase rates for DIAs and



other relevant factors. Regardless of the timing or number of transfers, all DIA Payments under a Rider will commence on the same date and will be paid over the same duration with the same annuitant, payment frequency, and period certain (if any). The owner, annuitant, and beneficiary under the Rider are the same as under the Contract, and the annuitant and payout option cannot be changed after the first transfer to the Rider.

Transfers to the Rider are irrevocable in the sense that once an amount is transferred, it is no longer part of the Contract's Accumulation Value and therefore cannot be accessed via withdrawal or surrender or applied to any other payout option. If the owner or annuitant dies before DIA Payments start, a lump sum death benefit may become payable, calculated as the sum of all prior transfers to the Rider, with no interest or earnings thereon. The Rider's death benefit is added to the Contract's Accumulation Value at death and then is governed by the death benefit provisions in the Contract. If only a portion of the Accumulation Value is transferred to the Rider, all contractual benefits continue to apply to the remaining Accumulation Value, including the right to withdraw it, apply it to another payout option, or make another transfer to the Rider.

Under these facts, life annuity payments may commence from the Rider while the Contract otherwise remains in a deferred status. The issuing company requested and received several rulings on whether and how the partial annuitization rules of section 72(a)(2) will apply in such a situation. The IRS concluded that section 72(a)(2) will apply each time a partial transfer of Accumulation Value is made from the Contract to the Rider. The

IRS also concluded that, pursuant to section 72(a)(2), each such partial transfer will give rise to a separate contract for purposes of section 72, and that each of the resulting separate contracts (a) will be allocated a *pro rata* portion of the “investment in the contract” based on the percentage of Accumulation Value transferred, and (b) will have its own “annuity starting date.”

#### APPLICABLE LAW

Section 72(a)(2) addresses partial annuitizations of annuity contracts. It applies “[i]f any amount is received as an annuity for a period of 10 years or more or during one or more lives under any portion of an annuity . . . contract.” If section 72(a)(2) ap-

The IRS explains in PLR 201632004 that when the owner makes an “irrevocable election” to allocate some, but not all, of the Accumulation Value to the Rider, the DIA Payments will be made under a portion of the Contract while the remaining portion is “administered according to the terms of the Contract.”

plies, (A) the portion of the contract under which the annuity payments are received is treated as a separate contract for purposes of section 72, (B) the investment in the contract is allocated *pro rata* between each annuitized and non-annuitized portion of the contract for certain purposes under section 72, and (C) a separate annuity starting date is determined under section 72(c)(4) for each annuitized portion of the contract.<sup>4</sup> Congress enacted these rules in 2010 after the IRS initially and informally expressed the view that the section 72 regulations precluded partial annuitizations.<sup>5</sup> The statutory amendments were meant to extend “exclusion ratio” treatment to annuity payments made for life or at least 10 years under part of a contract while another part of the contract remains in deferred status.<sup>6</sup>

#### IRS CONCLUSIONS AND ANALYSIS

The IRS explains in PLR 201632004 that when the owner makes an “irrevocable election” to allocate some, but not all, of the Accumulation Value to the Rider, the DIA Payments will be made under a portion of the Contract while the remaining portion is

“administered according to the terms of the Contract.” The IRS then concludes that “the election to allocate a portion of the Accumulation Value to the Rider will be a transaction to which [section] 72(a)(2) applies.” This, in turn, led the IRS to conclude that, at the time of each partial transfer of Accumulation Value to the Rider:

- (A) Pursuant to section 72(a)(2)(A), a separate contract will be treated as arising for purposes of section 72,
- (B) Pursuant to section 72(a)(2)(B), for purposes of applying section 72(b) (regarding the exclusion ratio), section 72(c) (defining investment in the contract and other terms in section 72), and section 72(e) (regarding withdrawals and other non-annuity payments), a *pro rata* portion of the investment in the contract will be apportioned between the Contract and the separate contract that is treated as having arisen by virtue of the transfer, with the *pro rata* allocation determined as of the transfer date based on the percentage of the Accumulation Value transferred, and
- (C) Pursuant to section 72(a)(2)(C), a separate annuity starting date will be determined with respect to each separate contract that is treated as having arisen by virtue of a transfer from the Contract to the Rider.

The IRS also elaborated on the foregoing conclusions by addressing the treatment of withdrawals from the Contract and multiple transfers to the Rider. With respect to withdrawals, the IRS stated that if an owner transfers a portion of the Accumulation Value to the Rider and then takes a withdrawal from the remaining Accumulation Value in the Contract, “the withdrawal will be taxable under [section] 72(e) without regard to the investment in the contract that was allocated to the Rider, *i.e.*, to the separate contract that [section] 72(a)(2)(A) treated as arising when such transfer was made.”

With respect to multiple transfers, the IRS stated that if an owner makes additional transfers of a portion of the Accumulation Value after the first transfer, each subsequent transfer will give rise to a new, separate contract for purposes of section 72, and the conclusions listed above will apply to each of the separate contracts that is treated as arising from each partial transfer. Thus, for example, if the owner makes the first transfer on Date 1, new contract #1 will arise, and if the owner makes a second transfer on Date 2, new contract #2 will arise, and so forth.

#### RESOLVING THE CIRCULARITY IN THE STATUTE

The new ruling is the first PLR involving section 72(a)(2) and the first addressing a DIA rider attached to a deferred annuity. The ruling also implicitly addresses and favorably resolves a circularity in the statutory language of section 72(a)(2). The



circularity arises by virtue of the statute's reference to an amount "received as an annuity." Section 72(a)(2) states, in relevant part, that "if any amount is received as an annuity" under a portion of a contract, that portion will be treated as a separate contract with its own annuity starting date. This is circular in the sense that, without the separate contract and separate annuity starting date rules, an amount presumably could not be "received as an annuity" in the first place.

In that regard, the Code does not define the phrase "amount received as an annuity." The regulations under section 72, however, provide a comprehensive definition of the phrase. In relevant part, the regulations state that an amount is considered "received as an annuity" only if it is received on or after the "annuity starting date."<sup>7</sup> For this purpose, the regulations define "annuity starting date" as the later of (i) the date upon which the obligations under the contract became fixed, or (ii) the first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semi-annually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.<sup>8</sup>

Before Congress added section 72(a)(2) to the Code, there was considerable uncertainty about whether a partial annuitization could technically occur under the Code and regulations. This uncertainty was attributable to a view that an annuity contract can have only a single "annuity starting date" as defined above, apparently because the definition refers to the obligations under "the" contract becoming fixed.<sup>9</sup> If a contract can have only one annuity starting date, and an amount cannot be received as an annuity until on or after that date,<sup>10</sup> no such amount could be received until all values in the contract had been annuitized. In this respect, the view and the uncertainty it entailed effectively precluded partial annuitizations.

Congress resolved this uncertainty, with the Treasury Department's support,<sup>11</sup> by adding the "separate contract" and "separate annuity starting date" rules in section 72(a)(2)(A) and (C), respectively. Without those rules, a partial annuitization arguably cannot give rise to an "amount received as an annuity." It would seem incongruous, then, to interpret the statute as applying only when an amount is actually "received as an annuity" in the technical sense, since it is necessary for the special rules in the statute to apply before an amount can be received as an annuity in the first place.<sup>12</sup> In short, section 72(a)(2) cannot operate as intended if the statutory language were interpreted to require that an amount must first be "received as an annuity" before the statute will apply.

The IRS resolved this circularity problem in PLR 201632004 by concluding that section 72(a)(2) will apply each time Accumulation Value is transferred to the Rider, even though the "annuity

starting date" with respect to the resulting DIA Payments may not occur until much later. This conclusion essentially treats each transfer to the Rider as an annuitization that triggers section 72(a)(2). This makes perfect sense in the context of a DIA. Under a DIA, annuity payments are "locked in" with each premium payment (or, in this case, with each transfer to the Rider). In this sense, the act of paying a premium under a DIA is the equivalent of (or closely resembles) a more traditional annuitization, such as one involving an immediate annuity where the payments likewise are locked in once the premium is paid. In that regard, the IRS seems to have based its conclusion in part on the fact that a transfer to the Rider is an "irrevocable election" of DIA Payments.

#### FACILITATING THE PROPER TREATMENT OF WITHDRAWALS

The conclusion in PLR 201632004 that section 72(a)(2) applies each time part of the Accumulation Value is transferred to the Rider also facilitates the proper treatment of subsequent withdrawals from the Contract. If section 72(a)(2) did not apply at that time, the separate contract rule of subparagraph (A) and the *pro rata* basis allocation rule of subparagraph (B) would not apply then, either. This could mean that a transfer of Accumulation

The IRS resolved this circularity problem in PLR 201632004 by concluding that section 72(a)(2) will apply each time Accumulation Value is transferred to the Rider, even though the "annuity starting date" with respect to the resulting DIA Payments may not occur until much later.

Value to the Rider would reduce the cash value of the Contract but not the "investment in the contract," thereby depressing the "income on the contract" for purposes of applying section 72(e) to subsequent withdrawals.<sup>13</sup> The conclusions in PLR 201632004 avoid this result by triggering the separate contract and *pro rata* basis allocation rules at the time of each transfer, thereby ensuring that when the transfer reduces the Contract's cash value both the gain and basis are reduced in appropriate amounts.



### AGGREGATION RULE

The conclusions in PLR 201632004 also implicitly confirm that the aggregation rule of section 72(e)(12) does not apply under the facts presented. Section 72(e)(12) provides that all annuity contracts issued to the same policyholder by the same company in the same calendar year shall be treated as a single annuity contract when applying section 72(e) to withdrawals from any of those contracts. Thus, a withdrawal from any one of the aggregated contracts is taxable under section 72(e) to the extent that the sum of all the contracts' cash values exceeds the sum of their "investment in the contract." Because the IRS concluded in PLR 201632004 that the Contract and Rider would be treated as separate contracts when the partial annuitization rule of section 72(a)(2)(A) applies, a question might arise regarding whether those separate contracts nonetheless are treated as a single contract pursuant to the aggregation rule.

PLR 201632004 implicitly confirms this is not the case. The IRS specifically concluded that "if the Contract owner takes a withdrawal from the Contract following an election to allocate Accumulation Value to the Rider, the withdrawal will be taxable under [section] 72(e) without regard to the investment in the contract that was allocated to the Rider." If section 72(e) will apply without regard to the transferred investment in the contract, which is treated as held under an entirely separate contract, then section 72(e)(12) must not be operating to aggregate those contracts for purposes of section 72(e). The PLR does not specifically discuss this, but the point follows from the foregoing IRS conclusion.

### NON-TAXABLE TRANSFERS TO THE RIDER

It also is inherent in PLR 201632004 that the transfer of Accumulation Value from the Contract to the Rider is not a taxable distribution. For example, the ruling does not suggest that a deemed exchange will occur when an amount is transferred to the Rider, such that section 1035 would need to be available to make the transfer non-taxable.<sup>14</sup> Rather, each transfer gives rise to an entirely new contract for purposes of section 72, pursuant solely to the statutory language of section 72(a)(2)(A). This also would seem to render the IRS guidance on partial exchanges irrelevant to the transaction.<sup>15</sup>

### MULTIPLE VS. SINGLE EXCLUSION RATIO(S)

A further implication of PLR 201632004 is that a separate exclusion ratio will be calculated with respect to each of the separate contracts that section 72(a)(2)(A) treats as arising with each transfer of Accumulation Value to the Rider. Thus, for example, if the owner made two transfers of Accumulation Value to the Rider, two new contracts would be deemed to arise, and an exclusion ratio would be calculated for each of those new contracts. However, because all of the DIA Payments under any given Rider will commence on the same date and have the same payment terms based on the same annuitant, it is likely that a single exclusion ratio could be calculated for all of the DIA Payments resulting from multiple transfers to the Rider and produce the same result as calculating separate exclusion ratios for each stream of DIA Payments.

### CONCLUSION

PLR 201632004 is the first ruling to address section 72(a)(2) or the treatment of a DIA rider to a deferred annuity. In the ruling, the IRS took a reasonable approach to resolving an inherent circularity in the statutory language of section 72(a)(2) that otherwise could have prevented the statute from applying to any partial annuitization. The IRS also interpreted and applied the statute in a way that favorably addresses some of the peculiar issues that arise by virtue of a partial annuitization occurring through a DIA payout option. The conclusions reached in the PLR facilitate the product design and ensure its proper tax treatment under section 72. ■

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## ENDNOTES

- <sup>1</sup> May 3, 2016.
- <sup>2</sup> Unless otherwise indicated, each reference to a “section” means a section of the Internal Revenue Code of 1986, as amended (the Code).
- <sup>3</sup> “Non-qualified” means the contract is not part of a tax-qualified retirement plan described in section 4974(c).
- <sup>4</sup> See section 72(a)(2)(A)-(C).
- <sup>5</sup> See The Small Business Jobs Act of 2010, Pub. L. No. 111-240 § 2113. The provision was effective for tax years beginning after December 31, 2010. The legislative history largely repeats the statutory language without elaborating on its meaning. See STAFF OF THE Jt. COMM. ON TAX’N, *Technical Explanation of the Tax Provisions in Senate Amendment 4594 to H.R. 5297, The “Small Business Jobs Act of 2010,” Scheduled for Consideration by the Senate on September 16, 2010*, at 44 (Jt. Comm. Print 2010).
- <sup>6</sup> “Exclusion ratio treatment” means the periodic payments will be taxable under the *pro rata* rule in section 72(b), which generally provides that a portion of each annuity payment will be treated as a tax-free return of basis and a portion will be taxable income. In contrast, distributions from an annuity contract that are not entitled to exclusion ratio treatment are either fully taxable or taxable under an “income first” ordering rule. See section 72(e)(2)(A) and (B).
- <sup>7</sup> Treas. Reg. section 1.72-2(b)(2)(i). The other requirements for an amount to be treated as “received as an annuity” are (1) the amount must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and (2) except in the case of variable annuity payments, the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory. Treas. Reg. section 1.72-2(b)(2)(ii) and (iii).
- <sup>8</sup> Treas. Reg. section 1.72-4(b)(1).
- <sup>9</sup> See, e.g., section 5.02 of Rev. Proc. 2008-3, 2008-1 C.B. 110 (listing partial annuitizations as an area under study on which the IRS would not issue rulings). We understand that the Service’s prior no rule position was attributable largely to the view described in the text above.
- <sup>10</sup> See Treas. Reg. section 1.72-2(b)(2)(i) (providing that an amount is received as an annuity only if, *inter alia*, it is received on or after the “annuity starting date”).
- <sup>11</sup> See Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals, at 74 (Feb. 2010) (proposing legislation to clarify the treatment of partial annuitizations so as to encourage such transactions).
- <sup>12</sup> In addition, section 72(a)(2) refers to an amount being received as an annuity “for a period of 10 years or more or during one or more lives . . .” This reference necessarily contemplates the *future* receipt of an “amount received as an annuity.”
- <sup>13</sup> A withdrawal from the Contract would be an amount that is “not received as an annuity” within the meaning of section 72(e)(1)(A)(ii) and would be received before the “annuity starting date” for the Contract. In such case, section 72(e)(2) provides that a withdrawal from the Contract will be included in gross income to the extent allocable to “income on the contract.” Section 72(e)(3) provides that an amount is allocable to “income on the contract” to the extent that such amount does not exceed the excess (if any) of (i) the cash value of the contract (determined without regard to surrender charges) immediately before the amount is received, over (ii) the “investment in the contract” at that time. As indicated in the text above, the Contract’s Accumulation Value is reduced dollar-for-dollar by amounts transferred to the Rider. Assuming that the Accumulation Value is the Contract’s “cash value” within the meaning of the foregoing rules, which seems likely but was not addressed in the ruling, a transfer to the Rider thus reduces the Contract’s cash value. If the “investment in the contract” were not also reduced, the result would be a reduction in the excess of the cash value over the investment in the contract, making it less likely that any withdrawal proceeds would be “allocable to income on the contract” for purposes of section 72(e)(3).
- <sup>14</sup> Section 1035 provides a nonrecognition rule for the exchange of an annuity contract for another.
- <sup>15</sup> See Rev. Proc. 2011-38, 2011-30 I.R.B. 66 (providing that (1) the IRS will treat a partial exchange of annuity contracts as a nonrecognition event under section 1035 if, *inter alia*, no amount, other than an amount received as an annuity for a period of 10 years or more or during one or more lives, is received under either contract within 180 days following the transfer, and (2) in other cases the IRS will characterize a transaction “in a manner consistent with its substance, based on general tax principles and all the facts and circumstances.”).

# Subchapter L: Can You Believe It? The Internal Revenue Code Requires Companies to Use Statutory Reserve Assumptions for Tax Reserves (Except Where It Doesn't)

By: Peter H. Winslow

Insurance tax professionals sometimes downplay the role of statutory reserves in the computation of tax reserves, asserting that Federally Prescribed Reserves are required to be computed in accordance with I.R.C. § 807(d). This is an incomplete and often misleading way to describe the tax reserve provisions. In fact, the proper starting place for computing tax reserves is not I.R.C. § 807(d), which provides certain rules for computing life insurance reserves, but I.R.C. § 811, the Internal Revenue Code (the Code) section that sets forth the accounting requirements for determining life insurance company taxable income. This hierarchy of relevant Code provisions has important ramifications in determining deductible tax reserves.

I.R.C. § 811(a) provides a general rule that taxable income for life insurance companies shall be determined using the accrual method of accounting. But, this Code provision goes on to add the following qualification to the general accrual accounting rule:

To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

In the 1977 *Standard Life & Accident*<sup>1</sup> case, the Supreme Court interpreted similar language in the predecessor of I.R.C. § 811 to mean that NAIC accounting principles must be used for tax



reserves because accrual accounting concepts are not applicable. In that case, the Supreme Court further concluded that accrual accounting should not apply to exclude unaccrued net deferred and uncollected premiums from gross income because doing so would be inconsistent with NAIC accounting. This Supreme Court holding was overturned by Congress in the 1984 Act. Congress amended the accounting provisions in what is now I.R.C. § 811(a) to legislatively reverse the holding of *Standard Life & Accident* as it related to the timing for recognition of premium income. As a result, premium income is now determined on an accrual basis and unaccrued deferred and uncollected premiums are no longer included in gross income. To make sure that premium income and reserve deductions remained matched, a special provision was added in I.R.C. § 811(c)(1) to exclude deferred and uncollected premiums from tax reserves. Importantly, however, the 1984 Act did not change the Supreme Court's holding as it related to tax reserves generally; I.R.C. § 811(a) carried over the basic rule that NAIC accounting rules apply to tax reserves, *i.e.*, because tax concepts of accrual accounting do not apply to insurance reserves, which Subchapter L specifically allows as deductions.

It is true that the 1984 Act added new I.R.C. § 807(d) that sets forth specific rules for computing some tax reserves. That Code section provides that life insurance reserves in most, but not all, cases should be computed using the NAIC-prescribed tax reserve method, specified prevailing mortality and morbidity tables and assumed rates of interest. The § 807(d)-mandated tax reserve method and assumptions do not operate in a vacuum, however; they are adjustments made to statutory reserves. The legislative history makes this clear:

Thus, in computing the Federally prescribed reserve, a company should begin with its statutory or annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well as the elimination of any net deferred and uncollected premiums (*see* new sec. 811(c)) and the elimination of any reserve in respect of “excess interest” guaranteed beyond the end of the taxable year (*see* new sec. 811(d)). Except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve. . . should be consistent with those employed in computing a company’s statutory reserve.<sup>2</sup>

A conclusion that the computation of tax reserves begins with statutory reserves has important consequences when a company makes a change to a statutory reserve assumption by adjusting a factor not prescribed by I.R.C. § 807(d). Is it necessary to make a change to tax reserves to conform with the changed statutory reserve assumptions? The answer is usually yes; I.R.C. § 811(a) requires this result.

Let’s examine a few examples dealing with lapse assumptions to illustrate how I.R.C. § 811(a) and § 807(d) interact. Suppose the NAIC-prescribed reserve method applicable for a particular type of contract at the time the contract was issued permitted lapses to be taken into account in establishing statutory reserves, but otherwise did not specify how the lapse assumptions were to be determined. At contract issuance, the company established statutory reserves using the NAIC-prescribed method with certain lapse assumptions, but in a subsequent year changes these assumptions. In such case, as required by I.R.C. § 811(a), the company should change its tax reserve lapse assumptions to conform to the change in statutory reserves. The statutory reserve lapse assumptions should be conformed to the statutory reserve assumptions whether they were originally “locked-in” and later changed, or whether the reserve method initially adopted by the company contemplated the unlocking of lapse assumptions anticipating that the assumptions would be updated periodically. It should be noted, however, that when the NAIC-prescribed method requires, or the company’s adopted method includes, the unlocking of lapse assumptions, the periodic updates proba-

bly would not rise to the level of changes in basis of computing reserves subject to the ten-year spread rule of I.R.C. § 807(f) because the periodic updating would be considered an integral part of the original tax reserve method.

Now assume the same facts except that at the time the contract was issued only particular lapse assumptions, or a range of assumptions, were permissible under the then-applicable NAIC-prescribed reserve method. The company initially used permissible assumptions, but later updated its statutory reserves to use lapse assumptions based on post-issue-date experience that were not permissible at the time the contract was issued. In such case, as required by I.R.C. § 807(d), the changed statutory reserve assumptions should not be used for tax reserves and should be adjusted to conform to the NAIC-prescribed method applicable at the time the contract was issued. The new lapse assumptions would not be permissible for tax reserves because they are inconsistent with the tax reserve method which is determined under I.R.C. § 807(d)(3) at the time the contract was issued.

The role of I.R.C. § 811(a) may have important implications for tax reserves when VM-20 becomes effective in 2017. For exam-

A conclusion that the computation of tax reserves begins with statutory reserves has important consequences when a company makes a change to a statutory reserve assumption by adjusting a factor not prescribed by I.R.C. § 807(d).

ple, the Valuation Manual provides an elective transition rule that permits companies, on a block-by-block basis, not to apply VM-20 to contracts issued up to three years after the operative date. Therefore, the companies can comply with the Commissioners Reserve Valuation Method (CRVM) for contracts issued during 2017-2019 either by changing to the VM-20 method or sticking with the old method. After its effective date in 2017, will VM-20 be the tax reserve method prescribed by I.R.C. § 807(d) even for companies that have elected to defer implementation for statutory reserves? The answer is no and here are the two

steps that lead to this conclusion. First, we start under I.R.C. § 811(a) with statutory reserves—in this case reserves computed using the pre-VM-20 method during the transition period. Next, we make an adjustment to statutory reserves only if I.R.C. § 807(d) dictates something else. In this case, a change would not be required for tax reserves because the pre-VM-20 method is fully compliant with the NAIC-prescribed CRVM at the time the contract is issued, *i.e.*, it is a proper tax reserve method as defined in I.R.C. § 807(d)(3).

So, the basic tax reserve rule is that statutory reserve assumptions must be used to determine the deduction for tax reserves, except where something specific in the Code tells us an adjustment must be made. ■

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#### ENDNOTES

<sup>1</sup> *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).

<sup>2</sup> Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 599 (1984). See also S. Prt. No. 98-169, vol. I, at 540 (1984).

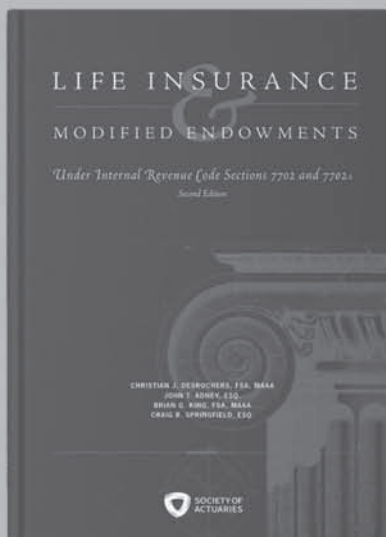


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