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## WELCOME, HELEN HUBBARD

By Mark S. Smith

In July 2013, the Internal Revenue Service (IRS) chief counsel appointed Helen M. Hubbard as the associate chief counsel (Financial Institutions and Products). Her office (sometimes referred to in tax circles as “FIP”) includes four branches that are generally responsible for non-insurance issues affecting financial institutions and products, a branch responsible for tax-exempt bonds, and of course the insurance branch (with which our readers are very familiar). Because of the office’s important role in the taxation of insurance companies and products, the *TAXING TIMES* Editorial Board and the Taxation Section Council thought our readers would appreciate the opportunity to meet Helen Hubbard and welcome her to the insurance tax actuarial community.<sup>1</sup> Mark Smith of our editorial board recently met with Ms. Hubbard to talk about her background and her new role.

**SMITH:** Helen, thank you for taking the time to talk with us; I know how very busy you are in your new role. Could you share a little bit about your professional background and the professional path that has led you to FIP?

**HUBBARD:** Thanks, Mark. Few people know this, but my father was a tax professor and also a retired partner from a Big Four accounting firm. He was so thoroughly dedicated to tax and compelled to teach that he did so even at home. Many of my most enduring lessons about federal income taxation were over breakfast and dinner. I was originally supposed to be a doctor, but was excused from that career path when my younger sister graduated from medical school and married another doctor, both on the same day. That was a good thing, because I always considered myself a natural-born tax lawyer. When confronted with a rule, I would always examine it from every angle, exploring each exception and permutation, always with a goal of finding a fair and sensible result.

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## FROM THE EDITOR TO OUR READERS

By Kristin Norberg

“If I have seen a little further it is by standing on the shoulders of giants.”

- Isaac Newton, 1676

It is a great honor for me to introduce myself to our readers as the new editor of *TAXING TIMES*.

This is a post I have long aspired to hold, though I certainly didn't anticipate taking it on under such difficult circumstances. As many of you know, it has been a very challenging year for tax actuaries, with the passing of both Chris DesRochers and Bud Friedstat in 2013, others facing illness, and several more moving quickly toward retirement. I have looked up to these people as teachers and mentors, worked with them as colleagues, and gotten to know a few of them as friends. It's been difficult to say good-bye.

I remember attending my first Product Tax Seminar back in 2006: Meeting Chris, John Adney, Doug Hertz, Brian King—names we know well from their years of contributions to the field, as well as their presence on the cover of *Life Insurance and Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A*. Learning that actuaries, attorneys and accountants had made careers out of insurance tax and found it as intricate and fascinating as I did, and getting to see IRS and Treasury personnel in the flesh ... it was truly a life-changing experience for me!

And now, eight years after that first encounter with the “giants” in our field, I am grateful to Chris and all the other pioneers in our special corner of the insurance world. I appreciate the massive efforts of Brian, Chris, Christine Del Vaglio, and everyone else who was part of the impressive infrastructure of *TAXING TIMES* in its first nine years. I thank Brian and the Taxation Section for entrusting this newsletter to my care, and I look forward to guiding it through the next phase of its existence. Finally, I offer my sincere appreciation to all of our authors, editorial board members, and support staff as we move forward together and maintain *TAXING TIMES* as the valuable and respected resource that it is today.

In this edition of *TAXING TIMES*, we are pleased to share an interview with Helen Hubbard, associate chief counsel (Financial Institutions and Products) in the IRS Office of Chief Counsel. Mark Smith from our editorial board sat down with her recently to learn more about her extensive background in both the public and private sectors. In the interview, Helen also describes the role of the FIP office relative to other parts of the Treasury Department and offers insightful perspectives on some of the issues facing FIP and the Insurance Branch in particular. We thank Helen for her valuable commentary, as well as the IRS for allowing us to conduct the interview.

This issue also contains the first installment of our new column, “In the Beginning... A Column Devoted to Tax Basics.” John Adney has written the inaugural article, which outlines the hierarchy of authorities in federal tax law and is a great read for novices and experienced

professionals alike. “In the Beginning...” is intended to be accessible to a broader audience, especially our younger Taxation Section members and those who may be branching out into tax from another specialty. To our longer-term readers out there, I encourage each of you to identify a colleague or team member whom you feel could benefit from expanding their knowledge base to include the taxation of life insurance products and companies. Share the column with them, now and in future issues, and start a dialogue about how taxes affect your company, clients, or customers. Consider sending them to the Product Tax Seminar this September or having them listen to recordings of meeting sessions sponsored by the Taxation Section. This is a fascinating field, and the interaction of actuaries, attorneys and accountants is one of my favorite aspects of what we do. We are always eager to welcome new members and affiliates to the section!

In addition to a number of updates on recent court activity and IRS rulings, this issue also contains a collaborative article on the Canadian and U.S. tax treatment of life insurance policies owned by citizens who move from one country to the other. In an age of globalization and international mobility, it seems that a company of almost any size has to be aware of cross-border issues, and coauthors Philip Friedlan and John Adney have provided a useful introduction to the taxation of life products on both sides of the border.

Enjoy this issue of *TAXING TIMES*, and please feel free to reach out to me anytime with suggestions, questions, or comments. ◀

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# FROM THE CHAIR

## SIGNS, SIGNS, EVERYWHERE SIGNS

By Brenna Gardino

**A**s I am writing this, I cannot tell you where the last few months have disappeared to and how it is possible that the signs of summer are starting to show. Here are some of my favorite signs of summer in Kansas City:

- Barbecue eating (outdoors!)
- Balmy humidity
- Fountains everywhere
- Continued optimism about the KC Royals
- Shoppers at the Country Club Plaza
- Competitive high school girls' basketball tournaments all weekend, every weekend (of course, that may just be my life and not all of KC ...)
- The countdown of school days left.

The last few months have been busy ones for the Taxation Section. In addition to the signs of summer, I am seeing signs of success from the diligent team focused on the attraction and development of the next generation of tax actuaries. As part of this effort, we are promoting the "Tax-Free Benefits of the Taxation Section" and have started getting the message out to local actuarial clubs. If you have a local actuarial club that may be interested in hearing more about the Taxation Section and volunteerism in general, please contact me.

Another sign of success is that this edition of *TAXING TIMES* features the first-ever "In the Beginning..." (great name, John!). This column will be an excellent addition to our publication and fits nicely with providing content for all levels of tax actuaries.

On September 10-12, 2014, the Taxation Section will host the popular Product Tax Seminar and Boot Camp. This event provides a unique learning and networking opportunity in Washington, D.C. This meeting is where I became addicted to product tax several years ago, and I highly recommend it.

Additional details can be found on the Society of Actuaries Web page or by contacting Brian King at [Brian.King3@ey.com](mailto:Brian.King3@ey.com). I hope to see some new faces at that meeting!

I would like to extend a big thank you to all of the dedicated friends of the council and council members for their time and hard work. I also hope you all see the signs of summer in your area and that you will help in the success of this section. Call me crazy, but I have a feeling this is the year for the KC Royals. ◀

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Save the Date

### 2014 Product Tax Seminar and Bootcamp

Sept. 10-12, 2014 • Washington, DC

I started my tax career with an accounting firm, Price Waterhouse. There, one of my first clients was a mutual insurance company that was new to the firm. I still remember the challenge of translating amounts reported on the annual statement to amounts reported on a federal income tax return. I know that exercise has grown more rewarding, shall we say, over the years as accounting and tax rules have become more complex.

After law school, my path led me down both the law firm and accounting firm routes at different times. Whereas at one point I would have expected that tax practice with a law firm was more interesting and challenging than with an accounting firm, I would say over time the practices of each have evolved. Immediately before joining the Treasury Department Office of Tax Policy as Tax Legislative Counsel in 2002, I was a partner with Ernst & Young.

I must say that my time at Treasury was possibly the most rewarding time in my professional life. Although much of my time there was spent on non-insurance issues such as capitalization of intangible assets and the section 199 deduction for domestic production activities, there was a significant amount of insurance work as well. For example, during my tenure we published two series of insurance revenue rulings, one on captive insurance, and the other on the investor control doctrine that applies to life insurance products. I love a challenge, and those insurance rulings fully met expectations.

For many of us, an element of professionalism is involvement in professional organizations. I have been privileged to serve the ABA Section of Taxation as vice chair of Government Relations, chair of the Accounting Methods Committee, and chair of the Code Simplification Task Force. Each of these experiences has broadened my appreciation for the challenges faced by companies in many different sectors, and the need for guidance that is clear and helpful.

**SMITH:** In your various past roles, what has been your experience dealing with the IRS generally, and with insurance issues specifically?

**HUBBARD:** In practice, I dealt primarily with the National Office in the context of Private Letter Ruling (PLR) requests, Technical Advice Memoranda (TAMs), and formal and informal interactions related to published guidance. I had significant experience in controversy matters with the Examination

Division and Appeals. I always hoped to litigate a case, but literally all my cases settled. Since joining the IRS Office of Chief Counsel, I've had the very welcome opportunity to participate in decisions concerning litigation of specific cases.

In my role at Treasury, I was responsible for all domestic tax issues except for employee benefits. As a result, I worked closely with individuals at all levels of the IRS and Office of Chief Counsel and in many different divisions. I really appreciated being on the inside, and participating in the development of guidance and in the decision making that affected people and companies. I particularly learned how important it is to work together with my counterparts at the IRS. Although our roles were different, we served the common goal of reaching the right answer.

In private practice, I advised non-insurance clients on insurance issues. For example, I gained a familiarity with captive insurance issues, and the taxation of retrospectively rated contracts. In this sense, I fully appreciate how important insurance issues may be to a taxpayer that is not an insurance company.

**SMITH:** You most recently served as vice president for Tax and Benefits at Fannie Mae. Why did you decide to rejoin the government, and why FIP?

**HUBBARD:** When I left Treasury, I had a notion that I would return to government service later in my career. I have always enjoyed work that is interesting and challenging, and I enjoy managing a team of people. In 2013, it appeared that the opportunity in FIP would be interesting and challenging—my most important criteria—and would be a solid fit for my background. I'm a strong believer in the importance of providing published guidance, and value the opportunity to re-engage in that process. Other dimensions of my position, such as coordinating FIP's litigation advice and answers to difficult questions in PLRs and TAMs, are new in some ways. In other ways, though, they are familiar in that they build on my experience as a lawyer and tax advisor.

I'm continually impressed by the breadth and quality of many of the dedicated people in FIP and elsewhere in the IRS. The institutional knowledge and history in this organization are extremely valuable. Again and again, the wealth of understanding of very technical issues and the history of positions

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the IRS has taken over the course of decades help the institution reach positions that are consistent and reasoned. I valued that when I was at Treasury. It was an important part of my decision to return to government service, and I feel so fortunate to work with the people here.

**SMITH:** What can you tell us about FIP? How big a role does the insurance branch play? What are some of the things the division does that are less visible to our readers?

**HUBBARD:** Well, there are a total of six branches in FIP, of which the insurance branch is one, and a little over 60 people. That is not to say the insurance branch is just a small or isolated part of the division. Far from it—insurance constitutes an important part of FIP’s work, and it is very important to me that the division’s branches work together carefully, so that positions are consistent (or, where different, are different for a reason). It is also important to me that the insurance branch—and the rest of FIP—work closely with other parts of the Office of Chief Counsel for the same reason. Because insurance companies typically own large portfolios of investment assets, the work of the other branches in the division also is important to the insurance industry.

FIP works closely with a number of constituencies. Obviously, we work closely with the Treasury Department’s Office of Tax Policy in formulating published guidance. We also work closely with taxpayers on what I would call “private guidance,” such as PLRs and TAMs, which apply to only a single taxpayer. We strive to be responsive to parts of the commis-

sioner’s organization, in particular the Large Business and International (LB&I) division, who are responsible for examining taxpayers and asserting positions that are legally correct and administrable.

In my mind, each of these groups of interested parties is more alike than different. I believe that most parties strive to reach the “right” answer and do not try to stretch or break the rules, even if their views of what is the right answer sometimes diverge. Each strives for administrable solutions to problems. I have yet to meet a tax practitioner inside or outside of government who would argue that complexity for its own sake is a good thing. In my current position, I am responsible for a team of highly trained attorneys who share these values.

**SMITH:** What have your first few months been like?

**HUBBARD:** A former government official whom I respect very much once said that stepping into a position like this is like drinking from a fire hose, and I think that’s a very good description. There is a tremendous amount of work in this division. Many of the issues we grapple with have a very long history, and I am still in the process of learning that history and the views of others involved in the process, so that I and the division can be as effective as possible.

Part of my job is to understand not only the technical merits of an issue, but also the relative priority of different projects. A great deal of time is sometimes spent on a relatively small number of issues. Obviously, the Affordable Care Act guidance and FATCA guidance have been very high priorities for the Office of Chief Counsel and Treasury. Items on the Priority Guidance Plan are by definition very important to the office as well. At the same time, we must devote appropriate attention to other issues that cross our desk. Needless to say, I’ve had a very busy first few months.

**SMITH:** In the past the Insurance Branch has worked somewhat independently of the rest of the division. Is that still the case, and do you have specific goals for the insurance folks who work for you?

**HUBBARD:** I don’t think it’s realistic to expect the Insurance Branch to be as fully integrated into the division as, say, the four branches that share jurisdiction over non-insurance FIP issues. After all, the strength of the Insurance Branch is its specialized knowledge and its deep history and understanding of the legal issues it is responsible for. I do, however, expect



that issues will be fully coordinated within the division so that, as appropriate, each project benefits from the full knowledge and experience of those who have something to contribute.

That is part of the philosophy of the office more generally than just the Insurance Branch or FIP. The Office of Chief Counsel has impressively thorough processes for the coordination of cases and issues among all the various specialties who have a stake in a particular issue. With such a strong team of experienced, specialized attorneys, why wouldn't we draw from the very best experiences and practices in the office?

**SMITH:** What do you think will be the one or two biggest issues or challenges facing FIP in the next few years?

**HUBBARD:** Well, certainly resources belong at or near the top of the list. We are learning to do more with less, and as you know we have made adjustments, particularly in the letter rulings program, to be sure our resources are put to the smartest use. This makes published guidance more important than ever. This is a much broader issue than just FIP, and part of my job as a manager is to find ways to be as effective as possible with the resources we have.

I would also say that the rapid pace of nontax developments makes our jobs as tax administrators more challenging. This is by no means unique to the insurance industry, but the insurance industry presents some pretty stark examples. For example, when the rules for life insurance companies were substantially rewritten in 1984, the notion that reserves might someday be determined stochastically, or might be principle-based, was likely far from anyone's mind. Similarly, the existing rules for life insurance products were written when those products were not nearly as complex as they are today. We need to find ways to make the existing rules work smoothly and produce appropriate results.

As I said earlier, I honestly enjoy a good challenge, so these are not "complaints"; rather they are "challenges." We all have tremendously interesting work and an important role in helping companies accomplish legitimate business transactions without running afoul of the relevant tax rules.

**SMITH:** How different is your new role in crafting guidance, compared with your former role when you were with the Treasury Department?

**HUBBARD:** I would describe my new role as very much more hands-on. When I was at Treasury, my office had responsibility for all domestic tax issues other than employee benefits. As important as FIP and insurance issues were to me then, I spent even more time on issues such as the capitalization of costs to create intangible assets and the newly enacted section 199 domestic production deduction. Now, I am responsible for a smaller number of projects that are very much more specialized. As a result, I often participate more directly in the drafting and development of these projects.

I would also say that my new role requires particular sensitivity to how guidance might be administered. This is simply a function of the somewhat different roles of the IRS and the Office of Tax Policy in the guidance. To me it is exciting to be in this role, and I really appreciate the wealth of experience that the entire division brings to the table.

**SMITH:** Would you say that your private sector experience has influenced your professional values? If so, how?

**HUBBARD:** As I said earlier, my belief is that most practitioners in all the various constituencies—taxpayers, the private tax bar, deal makers, revenue agents—simply want to reach the right answer. Often, when there are disagreements, those disagreements result from a lack of clarity. I believe that the Office of Chief Counsel can play a very important role in reducing controversy and reaching the right answer simply by providing guidance that is clear. This is what I find satisfying. A lot of time is spent in controversy over a small number of hard issues. If we can bring clarity, find workable solutions, and reduce costly time and controversy, everyone comes out ahead.

Much of my time in the private sector was spent on such contentious issues. Much of my time with the Treasury Department was spent on such contentious issues. I really get excited by the opportunity to help provide clear guidance and, as a result, reduce time-consuming controversy.

**SMITH:** What is the working culture that you hope to develop within FIP?

**HUBBARD:** I have a tremendous amount of respect for our attorneys. I know that some attorneys will spend their entire career in this office. I want to retain those attorneys and help them develop to their fullest professional potential. The office benefits greatly from the depth of their collective experience. I know that other attorneys will be here for just a few years and

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will move on to careers elsewhere, including in the private sector. I want those attorneys to develop professionally to the greatest extent possible while they are with our office. It is important to the general respect that the private sector holds for our office.

I'm proud to be part of this organization and want our attorneys to be proud as well, and to receive recognition for their important work.

**SMITH:** Is there anything else you would like to share with our readers?

**HUBBARD:** I appreciate the opportunity to get to know the Society of Actuaries Taxation Section and the readers of *TAXING TIMES*. I would repeat my earlier offer for section

members to reach out to talk with us about industry priorities and about issues they think we should be thinking about. I encourage that sort of dialogue personally and on the part of my staff. We value input from all interested parties. We're all in this together! ◀

#### END NOTES

- <sup>1</sup> *TAXING TIMES* previously interviewed William J. Wilkins, IRS chief counsel, 1 *TAXING TIMES*, Vol. 6, Issue 1 (February 2010), and Sheryl Flum, Branch Chief, Insurance Branch, 1 *TAXING TIMES*, Vol. 9, Issue 3 (October 2013).



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# IN THE BEGINNING ...

## A COLUMN DEVOTED TO TAX BASICS



### WHAT ARE THE SOURCES OF THE FEDERAL TAX LAW?

By John T. Adney

**W**hen seasoned practitioners of federal tax law see PowerPoint slideshows and like materials that reference “the IRS Code,” describe “regulations passed by Congress,” or discuss private letter rulings with a sense of awe, they immediately become skeptical (or more skeptical than usual) and begin hunting for errors. It is obvious to them, from the terms used, that the author is at best a novice when it comes to tax authorities, repeating information (and perhaps misinformation) obtained from others.

In the interest of avoiding such misadventures, this column—the first in a series intended to provide basic education on the federal tax law, with a focus on the rules applicable to life insurance products and companies—spells out in brief the hierarchy of authorities that establish and interpret that body of law. The reader will recall, from his or her seventh or eighth grade civics class, that under the U.S. Constitution federal laws emanate from acts of the two houses of Congress, subject to approval by the President. The federal tax laws are such laws, enacted by Congress and collected (since 1939) in an extensive statute known as the Internal Revenue Code or, for short, the “IRC” or the “Code.” This statute, divided into chapters and parts and sections, today is called the “Internal Revenue Code of 1986, as amended” and is reputed to be the largest body of tax legislation in world history. It constitutes all of title 26 of the United States Code, which contains most federal statute law.

Despite the mistaken allegations of various blogs and tax protestors, the Internal Revenue Service (IRS) does not write the rules contained in the Code. Only Congress can do that.

The IRS, as part of the executive branch of the government, has the job of enforcing the statute as written by Congress, and so in the first instance it must read and interpret what Congress has ordained. The IRS does have the role, working in conjunction with officials of the U.S. Treasury Department under grants of authority from Congress to the Secretary of the Treasury, of framing regulations that describe how the Code’s provisions should be interpreted. These regulations sometimes expand on more general concepts that appear in the Code and, where required or permitted by the Code, add some rules of their own. For example, the Code may use terms like “reasonable” or “substantial,” and the regulations may provide more detailed definitions and practical applications of those terms. Before being finalized, these regulations generally must first be published in proposed form (“proposed regulations”) in the Federal Register and be made available for formal comment by the general public, and the IRS and Treasury must review and provide written reactions to such comments, all following a process spelled out in the Administrative Procedures Act (the “APA”). Because all “final regulations” are issued in this manner and under authority granted in the statute, they typically are treated as having the force and effect of law under a doctrine the courts call “Chevron deference.” In urgent circumstances, “temporary regulations” may also be issued and take immediate effect, but these usually are published as proposed regulations, too.

In the absence of controlling regulations, and on occasion to determine whether a regulation contradicts the statute law—which it is not allowed to do—it is necessary to interpret the statute law itself. Indeed, where there is ambiguity in the

Despite the mistaken allegations of various blogs and tax protestors, the IRS does not write the rules contained in the Code. Only Congress can do that.

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statute as written by Congress (a situation that is not uncommon), interpretation is needed in order to frame regulations in the first place. Courts and commentators have written much on the techniques of interpreting legislative enactments, sometimes called the “canons of construction,” which range from using the rules of grammar to avoiding conflicts with the Constitution. In this connection, the interpreter can look to certain official explanations of congressional intent at the time the statutes were enacted, referred to as “legislative history.” This legislative history consists of published reports of the House Ways and Means Committee, the Senate Finance Committee, and the Conference Committee (which officially has the wondrous title, “The Committee of Conference on the Disagreeing Votes of the Two Houses”). It also includes floor statements of the members of Congress who are managing legislation and so-called “colloquies.” A colloquy is an orchestrated discussion that occurs on the floor of the House or Senate between the chairman of the committee of jurisdiction and another committee member for the purpose of clarifying or expanding on the wording of the legislation. These floor statements are preserved in the Congressional Record, the official journal of the proceedings of Congress. Materials prepared by the staff of the Joint Committee on Taxation are also useful as a form of (or as reflective of) legislative history. These include background materials prepared as a part of the legislative process as well as General Explanations, or Blue Books (so named because of their color), which are prepared

after the passage of major tax legislation. Because of their status as after-the-fact summaries, Blue Books do not have the same authoritative standing as contemporaneous legislative history (see the article “Blue Book Blues” in this issue).

A step down from the statutes, regulations, and legislative history are IRS pronouncements made in the course of administering the tax law. These include revenue rulings, revenue procedures, and notices, all of which are published in the *Internal Revenue Bulletin* and can be relied on by taxpayers. A revenue ruling states the IRS’ view of how the tax law should be interpreted and applied to specific facts; a revenue procedure describes the process a taxpayer can use to obtain a particular tax treatment, e.g., to change a method of accounting or correct a life insurance contract that violated applicable tax rules; a Notice makes an important announcement, such as outlining what future regulations will say or asking public input on a tax administration issue. In recent times, unfortunately, substantive guidance from the IRS in the form of revenue rulings has diminished. In litigation involving whether IRS positions are correct, the courts will not necessarily defer to this class of pronouncements, but will examine the matter independently. Reacting to a court decision of significance, the IRS also will publish an Action on Decision (or “AOD”), indicating whether the agency will “acquiesce” in a holding adverse to its view of the matter or will continue to argue for its position in future litigation. One famous acquiescence relevant to insurance involved a case called *Conway v. Commissioner*, 111 T.C. 350 (1998), in which the Tax Court held that a partial exchange of an annuity contract for another annuity could be tax-free under section 1035 of the Code. The IRS acquiescence in that case has spawned a number of revenue procedures and other items of guidance in its wake.

In addition, the IRS issues rulings relating to a single taxpayer, including private letter rulings (“PLRs”) requested by taxpayers and technical advice memoranda (“TAMs”) requested in the course of an audit. PLRs and TAMs are issued by the IRS Chief Counsel’s office in Washington, address the facts placed in front of the IRS, and have no precedential value beyond the taxpayers involved in them. However, they are disclosed to the public (after redacting taxpayer-identifying information), and tax practitioners read them because they serve to indicate the IRS’ thinking on the subject involved at the time they are issued. It is important to remember that a PLR is binding on the IRS only as to the taxpayer who sought it; in future circumstances, the IRS can change its mind. More recently, the IRS has tightened its rules on the issuance of PLRs,



and fewer appear to be emanating from the agency. Still other forms of non-precedential pronouncements appear from time to time. One is called the “FSA,” not to be confused with the SOA-awarded designation. This FSA stands for “field service advice,” in which Chief Counsel office lawyers outside of Washington advise revenue agents on various legal matters.

The reader will recall that there is also a third branch of the federal government: the judiciary. A taxpayer who disputes legal or factual determinations made by the IRS in an audit has the right to ask a federal court to review those determinations and reach an independent judgment as to the tax liability in question. A taxpayer may bring such a dispute to the Tax Court, and may do so without the need to pay the asserted tax deficiency up front. A case also may be filed in a federal district court or the Court of Federal Claims in Washington, although in those courts the tax (with interest and any penalties) must first be paid and a refund claimed. Occasionally, such a dispute can even reach the U.S. Supreme Court (again, see “Blue Book Blues”). The courts’ decisions typically are explained in opinions, sometimes called “case law.” Case law consists of judicial decisions, which usually have value as legal precedent and may be binding on the IRS and other courts depending on the circumstances. If and when called upon to interpret the Code, courts will first look to the statute, then to regulations, and then to the statute’s legislative history, and they will follow any prior case law that is binding in the matter. As noted above, IRS rulings and like pronouncements will be accorded a lesser status in judicial proceedings.

With this in mind, the reader may consider himself or herself duly educated in the sources of the federal tax law, and thus may join those practitioners who are suspicious of talk of the IRS Code and similar questionable phenomena. ◀

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## BLUE BOOK BLUES: THE SUPREME COURT DISCOUNTS THE VALUE OF THE JOINT COMMITTEE'S BLUE BOOKS IN *U.S. v. WOODS*

By John T. Adney

For many decades, the staff of the Joint Committee on Taxation of the U.S. Congress has prepared a summary, at or near the end of a congressional session, of significant tax legislation enacted during that session. This summary, officially known as a “General Explanation” and more commonly called the “Blue Book” because it is enclosed within blue covers, typically repeats the formal legislative history of enacted legislation—the House Ways and Means Committee and Senate Finance Committee reports, the Conference report, and sometimes floor colloquies and statements deemed important to the legislation. The Joint Committee staff may also supplement this history with additional discussion explaining or clarifying aspects of the enactment. In the latter connection, taxpayers and their representatives have been known to ask the staff to make such additions, all after the houses of Congress have moved on to other business.

Taxpayers, lawyers and accountants advising or representing taxpayers, and the Internal Revenue Service (IRS) itself have made use of the Blue Books’ statements regarding the various tax enactments in deciphering the import or arguing about the meaning of Internal Revenue Code (“IRC” or the “Code”) provisions. Many have found the Blue Books helpful as convenient repositories of what Congress has done, or at least what it said about what it did, in adding to or amending the Code. Perhaps more significantly, taxpayers, the IRS, and others have from time to time cited to statements in the Blue Books as authority for the positions they are taking or are urging on others. The status of the Blue Books as sources of authoritative guidance for interpreting the Code’s rules is of particular interest to the life insurance industry, as much of the legislation enacted in the 1980s that today governs the federal

income tax treatment of the industry’s companies and products is described in Blue Books issued by the Joint Committee staff (in 1982, 1984 and 1986). Quite often under that legislation, the legislative history represents much of the authority construing the Code’s provisions, and certain passages in the Blue Books speak to subjects not addressed anywhere else. By way of example, a footnote in the insurance-related matter in the 1984 Blue Book instructed actuaries on how to identify the interest rate and the mortality and expense charges used in the IRC section 7702 calculations for fixed premium universal life contracts; the substance of the footnote does not appear in the House and Senate committee reports.

Recently, the Supreme Court of the United States had occasion to consider just what official credence should be accorded to Blue Books. In *United States v. Gary Woods*, 571 U.S. \_\_\_, 134 S. Ct. 557 (2013), the Court considered whether the IRC section 6662(b)(3) 20 percent penalty for tax underpayments attributable to “substantial valuation misstatements” applied to an underpayment resulting from what the Court characterized as a basis-inflating tax shelter transaction. According to the Court’s opinion, Mr. Woods and his employer, Billy Joe McCombs, participated in an “offsetting-option” tax shelter (called by the ominous acronym “COBRA”) designed to generate large paper losses that they could use to reduce their taxable income. The tax shelter plan involved the use of an ostensible partnership and the creative application of the Code’s partnership tax rules, whereby the basis of Messrs. Woods and McComb in partnership interests they subsequently disposed of was claimed by them to be a substantial, positive amount. In this manner, the disposition of the interests produced a loss of some \$45 million, which in turn sheltered a comparable amount of the taxpayers’ income. The IRS thought, to the contrary, that their basis in the partnership interest should be zero, and in this connection it asserted against the taxpayers both a tax deficiency and the 20 percent penalty for substantial valuation misstatements, concluding that the taxpayers’ elevated basis claim was a misstatement warranting the penalty.

Certain passages in the Blue Books speak to subjects not addressed anywhere else.

Writing for a unanimous Court, Justice Antonin Scalia's opinion agreed with the IRS. With regard to the issue specifically before the Court, i.e., whether the district court that first considered the case had jurisdiction to determine that the valuation misstatement penalty applied, the opinion concluded that the district court could make that determination, reversing a contrary position adopted by the Fifth Circuit Court of Appeals. Much of the discussion in the Supreme Court's opinion centered on the applicability of this penalty and the jurisdiction of the district court to determine it in a so-called TEFRA partnership-level proceeding. At one point in the discussion, however, Justice Scalia came to one of his favorite subjects: the use of legislative history in the construction of congressional enactments. (For detail on the views of "textualists," as the Justice and others describe themselves, as well as for considerable commentary on the use and misuse of legislative history, see Antonin Scalia and Bryan W. Garner, *Reading Law: The Interpretation of Legal Texts* [Thomson/West 2012].)

Near the end of the Court's opinion, Justice Scalia addressed an argument raised by the taxpayers that was premised on the Blue Book issued by the Joint Committee staff in connection with legislation in 1981. In particular, the taxpayers had pointed to footnote 2 on page 333 of the "General Explanation of the Economic Recovery Tax Act of 1981" in support of their argument against application of the valuation misstatement penalty. The Court's opinion characterized the passage in the footnote as discussing "two separate, non-overlapping [tax] underpayments, only one of which is attributable to a valuation misstatement," and thus concluded that the passage was distinguishable from the facts of the *Woods* case. But the opinion did not stop merely by pronouncing the taxpayers' argument unpersuasive. Even before reaching the Blue Book text at issue, the Court spoke of the Blue Books as commentaries "written after passage of the legislation" that "d[o] not inform the decisions of the members of Congress who vot[e] in favor of the [law]," quoting from the Ninth Circuit Court of Appeals' decision in *Flood v. United States*, 33 F. 3d 1174, 1178 (1994). Then, citing to its own jurisprudence, the Supreme Court said that "[w]e have held that such '[p]ost-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation.'" While acknowledging that its own decisions "have relied on similar documents in the past, see *FPC v. Memphis Light, Gas & Water Div.*, 411 U. S. 458, 471-472 (1973), our more recent precedents disapprove of that practice."

The Court's opinion in *Woods* then drove something like a stake through the heart of any claim that the Blue Books could be cited as authority—and perhaps through the heart of those who would like to advocate the books' authoritative use, too. Specifically, the Court said, "[o]f course the Blue Book, like a law review article, may be relevant to the extent it is persuasive." That thought demotes the Blue Books down from the shelves of the statutes, and perhaps even down to the level of the article you are now reading. In any event, this should discourage parties arguing in front of the federal courts, and the Supreme Court in particular, from referencing the Blue Books in their filings.

The Supreme Court did not say in *Woods* that the staff of the Joint Committee on Taxation must cease and desist from publishing Blue Books; that would likely constitute a breach of the constitutional separation of powers. Nor should the Joint Committee staff even consider taking such a step. In addition to providing excellent tools for researchers in their collection and summary of official legislative history, the Blue Books serve as the voice of the Joint Committee staff in identifying issues in recent enactments, such as provisions warranting technical correction. Also, with due respect to the Court's suspicion of those who would add to the official

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gloss on an enactment after the President's signature has dried, the fact is that the Joint Committee staff members are heavily involved in the development of new or altered Code provisions and necessarily speak with more credibility than, say, academics writing articles. The Court, moreover, did not say that the IRS must completely ignore statements made in the Blue Books as it interprets the provisions of the Code. Under the regulations dealing with the IRC section 6662(b) (2) penalty for substantial understatement of income tax, and assuming the IRS does not alter the regulations in light of *Woods*, the Blue Books remain as a form of authority in determining whether there is "substantial authority" for a tax return position. See Treas. Reg. sec. 1.6662-4(d)(3)(iii).

The import of *Woods* is, in essence, that if anyone (even including the IRS) is planning to defend a chosen interpretation of a Code provision by pointing to legislative history, it should not include in those plans the use of the Blue Books, as such, in arguments to the courts. This teaching must carry over to tax advisors as well, for in rendering opinions on the construction of the Code, tax advisors must rely on authorities existing at the time the advice is rendered to assess (apart from penalties) how a court would decide the issue. While such authorities would include formal legislative history, they now would not appear to encompass the Blue Books themselves. ◀



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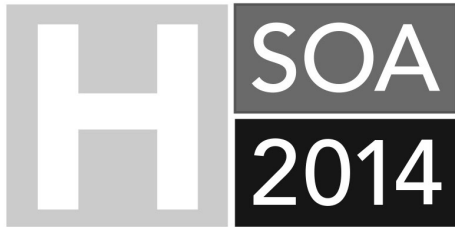
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## IRS APPLIES SECTION 817(a) AND (b) TO A NONLIFE COMPANY: WHAT DOES IT MEAN?

By Chuck Miller and Mark S. Smith

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One principle that frequently guides tax policy—and the interpretation of the Internal Revenue Code (the “Code”)—is that similarly situated taxpayers should be taxed similarly on transactions that are economically alike. Congress is thus generally explicit when it intends different rules to apply to similar transactions based solely on the identity or status of a taxpayer. For example, insurance companies are permitted to compute taxable income or loss using reserve methods of accounting for income or loss on insurance contracts, notwithstanding the “all events” test and “economic performance” requirements that govern the timing for deductions of other business taxpayers. And, corporations that elect to be taxed as regulated investment companies, real estate investment trusts and S corporations are subject to provisions that do not apply to corporate taxpayers more generally.

Within Subchapter L of the Code, specific rules apply under Part I (sections 801–818) to life insurance companies, under Part II (sections 831–835) to nonlife insurance companies, and under Part III (sections 841–848) to all insurance companies, regardless of whether they are life insurance or nonlife insurance companies. For some items, Parts I and II prescribe different accounting rules for life and nonlife companies. For example, Part I (section 808) permits a life insurance company to deduct “policyholder dividends paid or accrued during the taxable year,” whereas Part II (section 832(c)(11)) permits a nonlife company to deduct “dividends and similar distributions paid or declared to policyholders in their capacity as such.” For other items, such as the annual accounting period, measurement of discounted unpaid losses, and policy acquisition expenses (DAC), Part III prescribes rules that apply explicitly to both life and nonlife companies.

In a 2013 Chief Counsel Advice (CCA) memorandum, the insurance branch applied provisions of Part I of Subchapter L—which applies to life insurance companies—to a nonlife company taxed under Part II. CCA 201341033 (May 16, 2013, released Oct. 11, 2013) addresses a nonlife insurance company that issued variable annuities and maintained corresponding separate accounts. For purposes of computing its

insurance company taxable income, the company claimed a deduction for reserve increases resulting from both realized and unrealized appreciation in the separate account assets supporting the annuities. The company reported only realized capital gains on those assets, however. According to the company, unrealized gains did not have to be included in insurance company taxable income because the rules governing the adjustments to basis and the increase in reserves that generally apply under section 817(a) and (b) do not apply to a nonlife insurance company. According to the company, this limitation to realized gains and losses does not extend to the reserve increases and decreases, because those amounts were included in reserves for NAIC annual statement purposes and represented amounts owed to policyholders.

The operative rule for computing the taxable income of a nonlife insurance company under Part II of Subchapter L cross-references the rule in section 807 for computing life insurance reserves of a life company under Part I. In general, section 831 imposes a tax on a nonlife insurance company’s taxable income, including gross amounts earned from investment income and underwriting income as provided by the Code and computed on the basis of the annual statement underwriting and investment exhibit. The calculation of underwriting income accounts for both earned and unearned premiums. In particular, an increase in unearned premiums decreases taxable income, and a decrease in unearned premiums increases taxable income. Section 831(b)(4) explains that “unearned premiums shall include life insurance reserves, as defined in section 816(b) but determined as provided in section 807.” The question thus arises whether the cross-reference to section 807 in turn means that other provisions of Part I should apply to a nonlife company.

In CCA 201341033, the insurance branch concluded that the cross-reference to the rules for computing life insurance reserves of a life insurance company incorporates the rules of section 817 for accounting for gains and losses on separate account assets that support variable contracts. Section 817(a) adjusts the income or deduction that otherwise would result from a reserve increase or decrease by reason of appreciation



or depreciation of separate account assets. Section 817(b) correspondingly adjusts the basis of the separate account assets for the amounts to the extent appreciation and depreciation are from time to time reflected in reserves. Together, sections 817(a) and (b) permanently exclude capital gains on separate account assets at the company level to the extent such assets support variable contracts. Other than the cross-reference to section 807 (and, by extension, section 817's cross-reference to section 807), Part II contains no indication of the appropriate accounting for gains and losses on separate account assets.

Much of the analysis in the CCA relies on the legislative history of section 817, which was added to the Code by the Deficit Reduction Act of 1984 ("DEFRA"). That legislative history confirmed the operation of section 817(a) and (b) and its application to all variable contracts:<sup>1</sup>

[T]he company's basis in the assets underlying all variable contracts will be adjusted for appreciation or depreciation, to the extent the reserves are so adjusted. Thus, the corporate level capital gains tax is eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under present law.

The branch could have agreed, but did not agree, with the taxpayer that for a nonlife company, there is no requirement that reserves and asset basis be adjusted for unrealized appreciation in separate account assets, even though that same unrealized appreciation is appropriately accounted for in computing reserves with regard to the contracts the assets supported. Not only is section 817 a part of Part I of Subchapter L, which applies only to life insurance companies; section 817(a) itself applies "for purposes of subsections (a) and (b) of section 807." A nonlife insurance company, however, accounts for income or deduction by reason of changes in reserves under section 832(b), not under section 807(a) or (b). Such an approach, however, would have condoned a mismatch, because unrealized gains and losses would have been accounted for in computing deductions but not in computing the related income. That mismatch could not be corrected otherwise, such as by changing the clear instruction that life insurance reserves be computed as provided in section 807(d).

This is not the first time that the Internal Revenue Service (the "Service") has opted for policy considerations over a



mechanical reading of section 817. In PLR 201038008, the Service was asked to determine whether a separate account held by a foreign insurance company that elected to be taxed as a U.S. domestic insurer pursuant to section 953(d) was a segregated asset account as described in section 817(d). If so, contracts based on that account were variable contracts and subject to diversification requirements of that section. Section 817(d) states that an account is a segregated asset account if it is segregated from the general asset accounts of the company "pursuant to State law or regulation." The term "State" is defined, in section 7701(a), to mean one of the 50 states of the United States or the District of Columbia "where not otherwise distinctly expressed or manifestly incompatible with the intent of [federal tax law]." Even though the account was segregated pursuant to foreign law, the Service ruled that the account was a segregated asset account, in order to preserve equal treatment of the company's variable products with those sold by U.S. domestic carriers. The restrictive use of the term "State" would have been manifestly incompatible with the intent of U.S. tax law.

Another arguable ambiguity can be found in the Code itself. In the case of a U.S.-owned foreign insurer, section 954(i)(3) contains specific guidance in regard to "any contract which

Much of the analysis in the CCA relies on the legislative history of section 817.

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is a separate account-type contract (including any variable contract not meeting the requirements of section 817).” Since section 817 defines the term “variable contract,” the parenthetical expression in section 954(i)(3) could be read as a contradiction. That said, it achieves the “policy” goal of ensuring that economically similar contracts are covered.

The taxpayer that is the subject of the CCA clearly preferred to treat its variable annuities as not subject to section 817(a) and (b). The CCA doesn’t go into the reasons for this, but it is likely that the timing of reserve deductions relative to the income that created them is part of the story. In an equity market that generally rises over time, reserves will rise with unrealized appreciation. Absent section 817 (or section 817A if this were a modified guaranteed contract), those increases in reserves would be deductible, but the offsetting unrealized income would not be included in income until realized.

Of course, such “good timing” comes at a price; in this case, volatility of taxable income. In addition, the tax method could have unintended consequences for statutory accounting purposes. In order to establish the statutory deferred tax asset (DTA) under SSAP 101, the taxpayer must determine the amount of any temporary differences between statutory reporting amounts and the comparable tax reporting amounts. Such a temporary difference will be created for any unrealized losses taken through statutory income, but not through taxable income. The taxpayer must determine how much of

the temporary difference will reverse in three years (assuming the company’s risk-based capital [RBC] ratio exceeds 300 percent)<sup>2</sup>, since that is the amount that can be included in the taxpayer’s gross admitted statutory DTA. Also, for statutory filers without taxes paid in prior years, with admitted DTAs capped at 15 percent of adjusted surplus, or with statutory valuation allowances, the further risk is that the statutory DTA will drop in the presence of future unrealized gains, but cannot rise beyond the cap and other SSAP 101 limitations in the presence of future unrealized losses. This may add to the volatility of statutory surplus and could also impact the taxpayer’s risk-based capital (RBC) ratio.

Assuming a nonlife company were not in compliance with the position in the CCA, how would it actually adopt this guidance? It seems clear that some recognition would need to be given to the fact that this represents a change in timing. In implementing such a change, a number of things would need to be addressed, including the magnitude and nature of the changed elements. ◀

#### END NOTES

- <sup>1</sup> H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1054 (1984).
- <sup>2</sup> This limitation in SSAP 101 is based generally on the ratio of capital and surplus to the Authorized Control Level RBC. Most companies measure against the Company Action Level RBC; 300 percent of the Authorized Control Level is equivalent to 150 percent of the Company Action Level.

# CROSS-BORDER LIFE INSURANCE: DIFFERING DEFINITIONS IN AN AGE OF INTERNATIONAL TAX REPORTING

By Philip Friedlan and John T. Adney

*This article was previously published in Insurance Planning and is being republished with the permission of Federated Press.*

## INTRODUCTION

We wrote several articles in 2004-2005 that dealt with the tax consequences relating to life insurance policies owned by individuals when they moved across the Canadian-U.S. border.<sup>1</sup> Since that time and until recently, much of the current Canadian<sup>2</sup> and the U.S.<sup>3</sup> tax legislation as it relates to the taxation of holders of life insurance policies has basically remained unchanged.

However, the 2013 Canadian Federal Budget proposed changes in the rules applicable to leveraged insured annuity arrangements and so called 10/8 policies that are now law. In addition, draft legislation released in 2013 proposes significant changes to the exempt policy rules for policies issued after 2015.<sup>4</sup> Also, at the time we wrote our original articles, the Canadian Department of Finance had announced draft legislation relating to the taxation of foreign investment entities that contained specific provisions with respect to foreign insurance policies held by residents. The government did not proceed with those proposals.

Despite the absence of much substantive change in the insurance tax rules (thus far), there has been a significant development over the past few years where policyholder taxation is concerned: the greatly expanded reporting requirements for foreign financial assets. This topic will be dealt with towards the end of this article.

Using two simple fact patterns involving individuals, we will briefly review some of the current Canadian and U.S. income tax implications relating to life insurance when a resident of Canada emigrates to the U.S. and a U.S. citizen moves to Canada. In the first case, a Canadian resident (who is not a U.S. citizen) emigrates to the U.S. holding two policies issued on his or her life while resident in Canada by Canadian life



insurers – a universal life insurance policy (the “Cdn UL Policy”) and a ten-year level premium renewable term policy that has no cash value (the “Cdn Term Policy”). Each of these policies is an “exempt policy”<sup>5</sup> and is not registered as a deferred income plan. Since each policy is an exempt policy, income will only arise on the disposition of the interest in the policy.<sup>6</sup> In the second case, a U.S. citizen moves to Canada owning and being the life insured under a fixed, non-variable UL policy (the “US UL Policy”) and a ten-year level premium renewable term policy issued by a U.S. carrier (again, with no cash value) (the “US Term Policy”). Neither policy is connected with a tax-qualified retirement plan.

## CANADIAN TAX TREATMENT OF THE MOVE SOUTH

A Canadian resident is taxed on the person’s worldwide income.<sup>7</sup> A non-resident of Canada is taxable under the ITA on the non-resident’s taxable income earned in Canada which includes the income arising on the disposition of taxable Canadian property (“TCP”).<sup>8</sup> TCP is defined to include various types of property including a life insurance policy in Canada (“LIPC”).<sup>9</sup> An LIPC includes a life insurance policy issued by an insurer on the life of a person or resident in Canada at the time the policy was issued or effected.<sup>10</sup> In general, if a Canadian resident individual ceases to be resident in Canada, the ITA contains provisions that cause accrued gains and losses to be realized in the year of departure.<sup>11</sup> However, these rules do not apply to the Cdn UL Policy and the Cdn Term Policy because each policy is an LIPC.<sup>12</sup> Each of the policies is TCP and the non-resident holder will continue to be liable for income tax arising under the ITA on a disposition in respect of the policy, such as a surrender. In such event, certain procedures are imposed under the ITA and must be followed in the event of a disposition so that payment of the Canadian income tax is ensured.<sup>13</sup> In the event of the death of the life insured under these policies, the insurance proceeds will be tax-free under the ITA.

## U.S. TAX TREATMENT OF THE NEW RESIDENT

The United States imposes tax on the worldwide income of its citizens wherever they reside, and it taxes its non-citizen

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residents on generally the same basis. The scope of the U.S. taxing regime, including its extra-territorial reach, is central in examining the tax treatment of life insurance policyholders who cross the U.S. border, the key consideration being the U.S. tax definition of “life insurance contract.”<sup>14</sup> Very generally, this definition restricts the amount of cash value that a life insurance policy can provide in relation to its death benefit at any time, thus distinguishing it from annuities and investment products for tax purposes. The definition specifically recognizes a financial instrument as life insurance only if it is treated as such under the applicable law where it is issued (i.e., state law in the U.S., or the law of the non-U.S. issuing jurisdiction) and either (1) the policy’s cash value at any time cannot exceed the net single premium for its death benefit at that time,<sup>15</sup> viewing that death benefit as a level amount,<sup>16</sup> or (2) the gross premiums paid for it do not exceed a “guideline premium limitation” based on its death benefit,<sup>17</sup> and that benefit at any time is at least a statutory multiple of the policy’s cash value at that time.<sup>18</sup> Very broadly speaking, the rules allow life insurance treatment for a policy that is not more investment-oriented than a single premium, level-face endowment at age 95.<sup>19</sup>

If these requirements are met, the undistributed gain accruing in the cash value of a life insurance policy – the “inside buildup” – grows tax-deferred and there is no income tax on the policy’s death proceeds.<sup>20</sup> If not, there is accrual taxation of the inside buildup, assuming that the policy is not part of a tax-qualified retirement plan.<sup>21</sup>

When a former Canadian resident takes up U.S. residence, the individual will be taxed by the U.S. on his or her worldwide income, subject to the rules of the Canada-U.S. Income Tax Convention (1980)<sup>22</sup> and any applicable foreign tax credits. It will thus be necessary for the life insurance policies owned by the new resident to meet the requirements of the IRC in order to be treated as life insurance under the tax law. The Cdn Term Policy should comply with section 7702, since it was recognized as life insurance in Canada and its (zero) cash value cannot exceed the net single premium for its death benefit. The Cdn UL policy is more problematic, since its cash value may exceed the net single premium for its death benefit, and so to comply with the IRC, the past and future gross premiums paid for it must not exceed the guideline premium limitation for its death benefit. That benefit also must be at least the multiple of the contract’s cash value that is specified in section 7702.<sup>23</sup> The Cdn UL Policy could meet these re-

quirements, but this is not guaranteed, and making this determination would require actuarial testing. Second, the typical Cdn UL Policy may contain provisions not found in U.S.-issued life insurance, rendering their treatment uncertain.

If the Cdn UL Policy does not comply with IRC section 7702, accrual taxation of its inside buildup results, although, if the non-compliance occurred before the move to the U.S., it appears that only the income arising after residence was established should be taxable by the U.S. In the absence of actuarial testing, the best answer under U.S. tax law likely will be for the Cdn UL Policy to be exchanged for a U.S.-issued policy. This can be done tax-free under U.S. law, although such an exchange would be treated as a surrender of the existing policy and the acquisition of a new one under the ITA, resulting in a taxable event. This of course may not be feasible if there was a change in the insurability of the life insured.

#### U.S. TAX TREATMENT OF THE MOVE NORTH

Even though a U.S. citizen takes up residency in Canada, the Code views the citizen as remaining subject to its provisions. Thus, with respect to life insurance policies owned by a citizen, the usual rules will apply from a U.S. tax standpoint.

In planning for the move to Canada, a U.S. citizen should beware of acquiring *new* life insurance policies unless they comply with both the Canadian exempt test and the U.S. tax definition of life insurance (none are known to be issued by U.S. or Canadian insurers at this time). One practical option may be to try to ascertain if the US UL Policy per chance complies with the Canadian exempt test, and if it does, to learn how that status may be maintained (the US Term Policy will likely comply with the exempt test). If no other solution is found, consideration should be given to terminating the US UL Policy for otherwise it may be subject to accrual tax reporting in Canada.<sup>24</sup>

#### CANADIAN TAX TREATMENT OF THE NEW RESIDENT

Once resident in Canada, the holder of the U.S. policies will be subject to the rules in the ITA applicable to owners of life insurance policies, provided that each of the U.S. policies is a “life insurance policy”<sup>25</sup> under the ITA. If it is assumed that each of the U.S. policies would be regarded as a “life insurance policy” under the ITA, then when the U.S. citizen moves to Canada, he or she will be treated as having disposed of and

reacquired the U.S. policies at fair market value and will be subject to the rules under the ITA that apply to Canadian resident owners of life insurance policies.<sup>26</sup>

As a first step, therefore, it will be necessary to determine if each U.S. policy is an “exempt policy” under the ITA. In order to apply the test, the U.S. dollar denominated policies must be converted into Canadian dollars. The ITA and the regulations made thereunder do not contain any specific rules for determining whether either of these policies is an “exempt policy” in this situation. It will thus be difficult to apply the “exempt test” to the policy, even with actuarial assistance. It is very likely that the US Term Policy qualifies as an exempt policy. However, with the US UL Policy, this is uncertain. If it cannot be determined whether the latter policy is an exempt policy, consideration should be given to surrendering it before the move to Canada as noted above.

#### THE LATEST TREND – REPORTING ON FOREIGN FINANCIAL ASSETS

*Taxpayer reporting of foreign financial assets.* Taxpayers resident in Canada (with certain exceptions not relevant to this article) and certain partnerships are required to annually file an information return in respect of certain foreign property that they own.<sup>27</sup> Reporting is generally required where the person or partnership holds at any time in the year “specified foreign property” the total cost of which exceeds Cdn\$100,000.<sup>28</sup> Specified foreign property includes a variety of foreign property such as funds or intangible property deposited or held outside of Canada and shares of a non-resident corporation (other than a foreign affiliate) but does not include, among various types of property, personal-use property. Life insurance is not specifically listed as being specified foreign property.<sup>29</sup> The form to be filed is the T1135, “Foreign Income Verification Statement”.

As a result of the 2013 Canadian Federal Budget which reflected the federal government’s renewed focus on combating international tax evasion,<sup>30</sup> a revised T1135 form has been released by the Canada Revenue Agency which requires much more information than the old form. The instructions accompanying the form state that specified foreign property includes an interest in a foreign insurance policy.

U.S. persons also have reporting obligations on foreign financial accounts and assets. FinCen Form 114<sup>31</sup> must be filed to disclose interests in accounts maintained with foreign

financial institutions where the aggregate value exceeds US\$10,000. Such interests include life insurance and annuity contracts. In addition, IRS Form 8938 must be filed with the annual income tax return to disclose foreign financial assets – the instructions expressly include life insurance and annuity contracts in this – where the aggregate value exceeds US\$50,000 at the tax year-end or US\$75,000 at any time during the year. These thresholds rise to US\$100,000 and US\$150,000 for spouses filing jointly, and are reduced for individuals residing outside the U.S.

*Financial institution reporting of foreign financial accounts.* The required reporting by honest and diligent taxpayers does not, of course, remedy the problem of tax evasion by those who would hide assets offshore. In 2010, the U.S. Congress took a dramatic step to address this problem by enacting a group of Code provisions collectively known as “FATCA” – the Foreign Account Tax Compliance Act.<sup>32</sup> FATCA effectively forces non-U.S. financial institutions (“foreign financial institutions” or “FFIs”) worldwide to report to the IRS on the financial accounts of “U.S. persons” (i.e., taxpayers) by threatening the institutions with a 30 percent withholding tax on U.S.-source income. Many governments around the world have entered into “inter-governmental agreements” (“IGAs”) with the U.S.<sup>33</sup> to enable this reporting by their resident finan-

CONTINUED ON **PAGE 22**



cial institutions, often with a pledge from the U.S. that its own institutions would engage in reporting on those governments' nationals. Given the increasing focus of fiscal authorities on the problem of income tax evasion and the need for enhanced enforcement efforts across national boundaries, this is not surprising.

The regulations under FATCA (and the applicable IGAs) treat cash value life insurance (and annuity) contracts as financial accounts subject to reporting by "participating" FFIs, i.e., those that agree to report to the IRS and thereby avoid the withholding tax. The report is to show the U.S. person's name, address, account number, tax I.D. number, account value – meaning the cash value in the case of a life insurance contract – as of the annual reporting date, and any distributions made during the reporting period. As a result, in the case of life insurance contracts issued by carriers outside of the U.S. that are participating FFIs, the IRS will be apprised of the cash values of contracts owned by or for the benefit of U.S. persons.<sup>34</sup> The IRS will not know whether the contracts in question meet or do not meet the requirements of IRC section 7702; the FATCA regulations and the IGAs do not impose on participating FFIs the need to make such a judgment. But reports of significant cash values under contracts issued outside of the U.S. almost certainly will, in time, attract the attention of IRS auditors. As and when that occurs, the question of section 7702 compliance can readily be raised by auditors armed with the FATCA-generated reports.

And there is no reason to believe this would not work the other way. Canada certainly has as much official desire, if not need, to enforce its revenue laws as does the U.S. The 2013 Canadian Federal Budget stated that the federal government was negotiating with the U.S. for an agreement to enhance information exchange under the Canada-U.S. Tax Treaty, that the agreement would include information exchange provisions in support of FATCA, and that under the agreement information exchange would be improved on a reciprocal basis to facilitate tax compliance in both countries.<sup>35</sup> Apparently, Canada and the U.S. may be close to an agreement on this matter. As reciprocal reporting on the financial accounts of resident "foreign nationals" by local financial institutions becomes the international norm, Canadian revenue authorities will have access to information on persons with foreign-issued life insurance (among other foreign-based assets) who have become Canadian residents. Such information would

enable tax auditors in Canada to inquire about, and challenge, the exempt test compliance (or not) of a US UL Policy.

## CONCLUDING THOUGHTS

The existence of the differing tax-based definitions of life insurance, and the absence of relief under the Canada-U.S. tax treaty, pose a dilemma for life insurance policyholders who move across the border. Effectively forcing the surrender of a permanent life insurance policy to assure tax compliance makes little sense. A better solution, of course, would be for the migrating policyholder to obtain a new life insurance policy that complies with both the Canadian exempt test and IRC section 7702. This would provide the policyholder with the greatest protection, both insurance-wise and tax-wise, for at some point the migrant may return to the country of origin. The challenge lies in finding such a "dual-compliant" policy. Unfortunately, the authors are not aware of any U.S. or Canadian insurer that issues such a policy at this time. The prospect of enhanced reporting across the border may change the calculus in this respect. ◀

*Note from the Editor: On February 5, 2014, the U.S. and Canada finalized their inter-governmental agreement related to FATCA.*

## ENDNOTES

- <sup>1</sup> See for example "Life Insurance on the Move: Cross-Border Tax Implications & Opportunities for Canadian and U.S. Policyholders" published in CALU Report (October 2004)
- <sup>2</sup> Income Tax Act R.S. C. 1985 (5<sup>th</sup> Supplement c.1, as amended (referred to herein as the "ITA").
- <sup>3</sup> Internal Revenue Code of 1986, as amended (referred to herein as the "IRC" or the "Code"). The Code appears as Title 26 of the United States Code.
- <sup>4</sup> This draft legislation was released on August 23, 2013.
- <sup>5</sup> Definition of "exempt policy" in subsections 12.2(1) and 148(9.1) of the ITA and subsection 306(1) of the regulations made under the ITA.
- <sup>6</sup> Subsection 148(1) of the ITA.
- <sup>7</sup> Subsection 2(1) of the ITA.
- <sup>8</sup> Subsection 2(3) of the ITA.
- <sup>9</sup> Paragraph (1) of the definition of TCP in subsection 248(1) of the ITA.
- <sup>10</sup> Definition of LIPC in subsections 248(1) and 138(12) of the ITA.
- <sup>11</sup> Paragraphs 128.1(4)(b) and (c) of the ITA.
- <sup>12</sup> Definition of an "excluded right or interest" in paragraph 128(1)(10) of the ITA.
- <sup>13</sup> Subsection 116 of the ITA includes subsections 116(5.2) and (5.4).
- <sup>14</sup> IRC section 7702.
- <sup>15</sup> IRC section 7702(a)(1) and (b). This limit is referred to as the "cash value accumulation test."
- <sup>16</sup> IRC section 7702(e)(1).
- <sup>17</sup> IRC section 7702(a)(2)(A) and (c).
- <sup>18</sup> IRC section 7702(a)(2)(B) and (d) (subsection (d) sets forth multiples, known as the "cash value corridor," ranging from 250 percent through the insured's age 40 down to 100 percent when the insured reaches age 95).
- <sup>19</sup> Section 7702, along with section 7702A discussed below, is addressed in a comprehensive manner in DesRochers, Adney, Hertz, and King, *Life Insurance & Modified Endowments* (Society of Actuaries, 2004).
- <sup>20</sup> IRC section 101(a)(1). In certain instances, however, the death benefit can be taxable, e.g., where the policy has been transferred for value (see IRC section 101(a)(2), including exceptions provided therein).
- <sup>21</sup> IRC section 7702(g). Further, even if section 7702 is violated, the net amount at risk still passes to the beneficiary tax-free (see section 7702(g)).
- <sup>22</sup> Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983; March 28, 1984; March 17, 1995, July 29, 1997 and September 21, 2007. The Convention does not mention life insurance except in Article XVIII, Pensions and Annuities, which deals with the payment of pensions and annuities.
- <sup>23</sup> IRC section 7702(a)(2)(B) and (d).
- <sup>24</sup> A non-exempt policy is subject to annual accrual reporting under subsection 12.2(1) of the ITA.
- <sup>25</sup> "Life insurance policy" is defined in subsections 248(1) and 138(12) of the ITA.
- <sup>26</sup> Paragraphs 128.1(1)(b) and (c) of the ITA.
- <sup>27</sup> Subsection 233.3(3) of the ITA.
- <sup>28</sup> Definition of "reporting entity" in subsection 233.1(1) of the ITA.
- <sup>29</sup> Definition of "specified foreign property" 233.1(1) of the ITA.
- <sup>30</sup> Economic Action Plan 2013, tabled in the House of Commons by the Minister of Finance, March 21, 2013, at pgs. 154-155.
- <sup>31</sup> Formerly known as Form TD F 90-22.1
- <sup>32</sup> IRC sections 1471-1474.
- <sup>33</sup> It is anticipated that Canada will enter into an IGA with the U.S. by early 2014.
- <sup>34</sup> The IRS may have some information on the policies' existence if the premium payors report on and pay their excise tax liability under IRC section 4371 or if the FinCen Form 114 or the Form 8938 is filed, but apart from FATCA there is no required reporting of cash value amounts by the issuing insurer.
- <sup>35</sup> See footnote 30 at pgs. 155-156.



## ACLI UPDATE

By Pete Bautz, Mandana Parsazad, and  
Walter Welsh

### INTERACTION OF ACLI STAFF ACTUARIES, ACCOUNTANTS AND TAX PROFESSIONALS

*Note from the Editor: For several years now, TAXING TIMES has included an “ACLI Update” column to keep readers informed about the organization’s work on tax issues affecting the life insurance industry. In this issue, the editorial board asked Pete Bautz to describe their current organizational structure and how the ACLI interacts with various governmental and regulatory groups, such as the Department of the Treasury, the Internal Revenue Service and the National Association of Insurance Commissioners.*

The American Council of Insurers’ (ACLI’s) Actuarial Department and Taxes and Retirement Security (TRS) Department staff is comprised of a cross-functional team of accounting, actuarial and legal professionals who regularly work together—and with technical experts from our member companies—on a broad range of actuarial, financial and tax matters. The following provides an overview of the staff functions and their areas of expertise and overlap.

At the present time, the ACLI Actuarial Department, led by Senior Vice President and Chief Actuary Paul Graham, has eight employees, including three actuaries (Paul, John Bruins and Steve Clayburn) and an accountant (Mike Monahan). The ACLI TRS Department is headed up by Executive Vice President Walter Welsh and includes three attorneys (Walter, Pete Bautz and Mandana Parsazad) who focus on tax matters.

The Actuarial Department works closely with the ACLI State Relations staff and ACLI members primarily on actuarial and accounting matters under the jurisdiction of the National Association of Insurance Commissioners (NAIC) and the various state insurance departments. For instance, the Actuarial Department has provided the NAIC and state insurance departments with the life insurance industry perspective on comprehensive new actuarial standards like AG 43 and

principle-based reserves (PBR) or on new global accounting standards, as well as on discrete actuarial projects such as the development of new mortality and morbidity tables.

The TRS Department works closely with the ACLI Federal Relations staff and ACLI members on all matters that could affect the taxation of life insurance companies and products, including tax legislation (primarily federal tax legislation), and tax regulation and administration matters. For example, the TRS Department has provided staff of the congressional tax-writing committees with industry feedback on proposed tax law changes and has shared with the Treasury Department and Internal Revenue Service (IRS) the industry’s perspective on tax regulations or IRS rulings.

Changes to, or interpretations of, certain sections of the Internal Revenue Code (“IRC” or the “Code”) including, but not limited to, section 72 on the taxation of annuities, section 807 on the tax treatment of reserves, and section 7702 on the definition of a life insurance contract, often require regular multidisciplinary consideration by ACLI’s team of tax professionals, accountants and actuaries. A very current example of this type of ongoing coordination is found in the 2001 CSO mortality table guidance plan project, which is described in detail in the next ACLI update item, below. Similarly, as the NAIC and the U.S. and global accounting standard-setters have considered changes to actuarial and accounting standards, ACLI’s multidisciplinary staff regularly collaborate on the potential impact those changes might have on the tax treatment of insurance companies and products. Recent examples of this type of coordination include ACLI’s efforts to secure IRS guidance on the tax treatment of PBR and the inclusion of the AG 43 conditional tail expectation (CTE) amount in the section 807 statutory reserve cap.

This cooperation among ACLI’s multidisciplinary staff is extremely helpful, allowing for seamless consideration of issues as they arise.



## IRS PRIORITY GUIDANCE PLAN PROJECT ON 2001 CSO MORTALITY TABLES

The IRS 2013–2014 Priority Guidance Plan once again lists guidance clarifying whether the AG 43 CTE amount should be taken into account for purposes of the IRC section 816(a) Reserve Ratio Test and the section 807(d)(6) statutory reserve cap. During 2014, ACLI expects to work closely with the IRS on this guidance project. We will also continue to seek IRS guidance at the earliest possible time on the tax treatment of PBR, an issue that does not appear on the 2013–2014 Priority Guidance Plan.

For the past two years, the “Insurance Companies and Products” section of the IRS priority guidance plan has listed another project: “Guidance to clarify which table to use for section 807(d)(2) purposes when there is more than one applicable table in the 2001 CSO mortality table.” Over the last year, ACLI TRS and Actuarial Department staff have had several conversations with IRS Chief Counsel and Treasury Department staff regarding the nature and scope of this project. A little background information on this project is in order.

For purposes of computing the federally prescribed reserve in section 807(d)(2), section 807(d)(2)(C) provides that the “prevailing commissioners’ standard tables” for mortality and morbidity are used, adjusted as appropriate for risks not addressed in the table. Section 807(d)(5) explains that the prevailing commissioners’ standard tables are the most recent commissioners’ standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves under the insurance laws of at least 26 states. Section 807(d)(5)(E) then provides a special rule to address situations in which more than one mortality table or table option may apply. In these situations, section 807(d)(5)(E) requires that the table or table option “which generally yields the lowest reserves must be used for purposes of [section 807(d)(2)(C)].” It is this statutory language that the priority guidance plan is seeking to address.

We reviewed this issue with our members and made the following points to the IRS:

- The plain language of the Code calls for an industry-level determination of which table or table option generally produces the lowest reserve;
- The design of the federally prescribed reserve and its interaction with the statutory reserve cap reinforces an industry-level approach to section 807(d)(5)(E); and

- Life PBR—and the introduction of new mortality tables—provide an appropriate opportunity for mortality table guidance.

ACLI also recommended that the IRS and Treasury affirm (1) their long-standing interpretation of section 807(d)(5)(E) to the effect that the table (or table option) that generally yields the lowest reserve is determined at the industry level, rather than on a contract-by-contract or company-by-company basis, and (2) that the conclusions reached by the American Academy of Actuaries in connection with the development of the 2001 CSO mortality tables (i.e., that reserves produced by the ultimate table generally yielded the lowest reserve) should be relied upon.

We suggested that in the event the IRS and Treasury consider other approaches to guidance on the 2001 CSO table issue, the affected taxpayers should be given notice of those approaches and an opportunity to comment. Specifically, ACLI said that guidance inconsistent with the Service’s historic position in Rev. Rul. 87-26 and industry practice should (1) apply only to contracts written in the future, with adequate time to modify systems, contracts and pricing; and (2) be limited to future CSO mortality tables rather than the 2001 CSO table.

## SNFL CHANGE

The statutory valuation and non-forfeiture interest rates are dynamic. Therefore, it is possible in a prolonged very low interest rate environment for the statutory rate to drop below the 4 percent rate specified in IRC section 7702. If this were to happen, products using the cash value accumulation test (CVAT) would not qualify for federal tax treatment as life insurance. Last spring, the ACLI recommended to NAIC changes to the statutory standard non-forfeiture model law and the valuation manual to provide a temporary resolution to the potential conflict. ACLI recommended that the standard non-forfeiture law (SNFL) and the valuation manual be amended to set a floor for the minimum non-forfeiture interest rate at 4 percent. ACLI’s recommendation was approved by the NAIC at its December 2013 meeting. ACLI is advocating for state enactment of the model SNFL and standard valuation law changes in all 50 states and the District of Columbia. ◀

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## WHAT IS THE PROFESSIONAL DEVELOPMENT COMMITTEE AND WHAT'S IN IT FOR YOU?

By Beth Grice, Terry Long and Judy Powills

The Professional Development Committee's Top 10 Facts:

10. Otherwise known as the PDC, the Professional Development Committee is an SOA board of directors appointed committee.
9. The PDC was formed in 2009.
8. The PDC has overall responsibility for managing the development of the professional development (PD) curriculum (the content, method of delivery and resources provided to facilitate learning) reflecting the SOA's competency framework.
7. The PDC is charged with providing the highest quality learning experiences.
6. The PDC ensures that the PD program is focused on both current and forward-looking technical and non-technical content (state of the art).
5. The PDC ensures that the PD program makes use of instructional technologies to assure timeliness of, and broad access to (globally accessible), relevant and engaging programming.
4. The PDC fosters career-long learning.
3. The PDC is charged with ensuring that the SOA's PD program meets the needs of the profession and is aligned with the SOA strategic plan.
2. The PDC represents the SOA's constituencies including Canadian and international.

And No. 1 ...

The PDC represents you and your PD needs!

Approximately 75 percent of content developed for, and delivered to, SOA members comes from you—the sections! The sections and volunteers play vital roles in the planning, development and delivery of the SOA PD program. 2014 looks to be an exciting year for section-sponsored PD offerings—section plans reflect an array of offerings targeted to member needs—meeting sessions, seminars, webcasts, podcasts and more. Congratulations to the sections!

If 75 percent of content comes from the sections, where does the rest of the SOA's PD programming come from? The SOA partners with other organizations, actuarial and non-actuarial. The SOA also enters into strategic alliances with other organizations. The PDC is responsible for considering these strategic alliances. For example, if an organization is interested in delivering a seminar, it is required to submit a strategic alliance form to the PDC.

The PDC has the responsibility and authority to evaluate the proposals and make a decision as to the appropriateness of the relationship. The PDC also looks to SOA staff to set goals in support of the PDC's initiatives to develop and deliver quality curriculum to meet members' PD needs and support lifelong learning. Remember that the prequalification curriculum with new additions is available to the PD audience, too.

Learning technologies are rapidly changing. The PDC evaluates and makes recommendations for the adoption of new technologies to apply to PD programs—the best in webcasting, virtual sessions and podcasting. And, our e-Learning portfolio continues to expand, offering more for members' technical and non-technical knowledge and skill development.

In addition to overseeing the PD program for members, the PDC sets priorities on an annual basis to provide a comprehensive, progressive curriculum to meet upcoming needs. 2014 priorities include building/enhancing PD offerings for pension actuaries and actuaries internationally, offering more in the areas of business analytics and general insurance, conducting market research to better understand member needs and gaps, and letting you know about offerings and tools available. Did you know, for example, that you can purchase a group of business and communication skills e-courses from BizLibrary: <http://www.soa.org/bizlibrary/>? Do you know about Tools for Actuaries: <http://toolsforactuaries.org/>?

Check it out to find tools relevant to your development including books, e-books and training opportunities.

The PDC is a resource for you. Current PDC members representing the sections are:

- Beth Grice (PDC chair)—Health and Long Term Care Insurance Sections and liaison to the Health Meeting: [bgrice@humana.com](mailto:bgrice@humana.com)
- Peter Hayes—Pension and Social Insurance Sections: [phayes@eckler.ca](mailto:phayes@eckler.ca)
- Donald Krouse—Investment and Joint Risk Management Sections and liaison to the Investment Symposium and ERM Symposium: [dkrouse@aegonusa.com](mailto:dkrouse@aegonusa.com)
- Terry Long (PDC vice chair)—Product Development, Financial Reporting, Marketing & Distribution, Reinsurance, Smaller Insurance Company, and Taxation Sections and liaison to the Life & Annuity Symposium and Valuation Actuary Symposium: [tlong@lewisellis.com](mailto:tlong@lewisellis.com)
- Kevin Pledge—Actuary of the Future, Education & Research, Entrepreneurial Actuaries, Forecasting & Futurism, International, Management & Personal Development and Technology Sections and 2014 Annual Meeting Chairperson: [kevinpledge@gmail.com](mailto:kevinpledge@gmail.com).

The other PDC members are Jennie McGinnis (board partner), Lorne Schinbein (Education Executive Group curriculum chair), Genghui Wu (international constituency), Mike Boot (SOA managing director—Sections & Practice Advancement) and Judy Powills (SOA senior director of Curriculum and Content Development). PDC members are also assigned to board-appointed teams including the Issues Advisory Committee, the International Committee and the Transfer Knowledge Team.

The PDC wishes to thank the sections for their contributions. Feel free to call upon us as your sounding boards for your ideas about PD content and delivery! ◀

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

#### DO WE FINALLY HAVE GUIDANCE ON SEPARATE ACCOUNT DRD?

By Susan J. Hotine

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The Internal Revenue Service (IRS) recently released Rev. Rul. 2014-7,<sup>1</sup> which addresses what is the amount of life insurance reserves taken into account under I.R.C. § 807 for a variable contract where some or all of the reserves are accounted for as part of a life insurance company's separate account reserves. Perhaps more important than what this ruling addresses is what it does not address. Rev. Rul. 2014-7 merely republishes the first, perhaps noncontroversial, holding of Rev. Rul. 2007-54<sup>2</sup> relating to the tax reserve amount for a variable contract. Rev. Rul. 2007-54 included a second holding, however, that stunned the industry with its conclusion that required interest for separate account reserves (which ultimately determines the company's share of the dividends-received deduction ("DRD")) should be calculated using the applicable federal interest rate.<sup>3</sup> This second holding would have had a significant negative financial impact on variable contract writers because following it would result in a substantial diminution to, if not elimination of, a company's share of the separate account's available DRD. The possibility of this negative financial impact was avoided by the publication of Rev. Rul. 2007-61,<sup>4</sup> which suspended Rev. Rul. 2007-54 and provided that the IRS would work on further guidance. Since 2007, every Priority Guidance Plan released by the Treasury Department and the IRS has included an item for "Revenue Ruling [or Guidance] on the determination of the company's share and the policyholders' share of the net investment income of a life insurance company under § 812." Rev. Rul. 2014-7 states that Rev. Rul. 2007-54 is modified and superseded, and that Rev. Rul. 2007-61 is obsoleted.

The first issue for consideration is: What does it mean when a ruling is modified and superseded? The IRS uses specific terms for explaining the effect that rulings have on previous rulings. In the "Definition of Terms" introduction of a Cumulative Bulletin, a ruling being "modified and superseded" is explained as describing "a situation where the substance

of a previously published ruling is being changed in part and is being continued without change in part, and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self-contained. In this case, the previously published ruling is first modified and then, as modified, is superseded."<sup>5</sup> Whereas the first holding of Rev. Rul. 2007-54 is republished, the major modification of Rev. Rul. 2007-54 made by Rev. Rul. 2014-7 is the deletion of the second issue and holding, along with the entire analysis related to it. Thus, it appears that the IRS no longer takes the position that required interest for a federally prescribed reserve ("FPR") accounted for as part of the separate account should be calculated using the higher of the applicable federal interest rate of the prevailing state assumed interest rate. This would be consistent with the Industry Director Directive ("IDD")<sup>6</sup> that has been in effect since May 2010. By contrast, the IRS continues to take the position that all reserves for a variable contract, whether accounted for in the general account or the separate account, are taken into account under I.R.C. § 807(d). Having been so modified, Rev. Rul. 2007-54 is superseded by Rev. Rul. 2014-7. Rev. Rul. 2007-61 is obsoleted because the reason for suspending Rev. Rul. 2007-54—the second holding—no longer exists.

The second issue for consideration then is what exactly does Rev. Rul. 2014-7 stand for? As indicated above, Rev. Rul. 2014-7 republishes the first holding of Rev. Rul. 2007-54; it describes the same facts for Situation 1 and Situation 2, changing only the tax years referenced to more current years (2012 and 2013). Situation 1 considers a variable annuity contract that neither provides supplemental benefits nor involves qualified substandard risks. The facts indicate that for each year the FPR for the contract (\$8,000 and \$10,000, respectively) is greater than the net surrender value (\$7,840 and \$9,830) and less than the statutory reserve (\$8,050 and \$10,045). Situation 2 considers the same variable annuity contract except that the contract provides a minimum guaranteed death benefit ("MGDB"). The facts indicate that for each year the total of the general account and separate account FPRs for the contract with the MGDB is larger than in Situation 1 (\$8,155 and \$10,165), but that the FPR for the contract without the MGDB (i.e., the separate account FPR) would have been the same as

in Situation 1 (\$8,000 and \$10,000). Also, in Situation 2, for each year the net surrender value of the variable annuity contract is equal to the FPR amount for the contract without the MGDB (\$8,000 and \$10,000), and the total statutory reserves for each year are greater than the total FPR for the contract (\$8,210 and \$10,215). Just like the first holding of Rev. Rul. 2007-54, Rev. Rul. 2014-7 holds that, under I.R.C. § 807(d) (1), the amounts of the end-of-year life insurance reserves for the variable annuity contract in both Situation 1 and Situation 2 are the amounts of the tax reserve determined under I.R.C. § 807(d)(2) (i.e., \$8,000 and \$10,000 for 2012 and 2013, respectively, for Situation 1, and \$8,155 and \$10,165, respectively, for Situation 2).

The authorities cited and the analysis in Rev. Rul. 2014-7 are the same as those for the first holding in Rev. Rul. 2007-54 with one exception. The analysis in Rev. Rul. 2007-54 included a final sentence that Rev. Rul. 2014-7 omits. The sentence said: “The allocation of obligations between general account reserves and separate account reserves has no effect on the determination of the amount of IC’s [the company’s] life insurance reserves for Contract A under section 807(d).” Instead of including this sentence, Rev. Rul. 2014-7 concludes its analysis with a statement that the ruling provides guidance only with respect to the determination under I.R.C. § 807(d) of the amount of the life insurance reserves for a variable contract when some or all of the reserves are accounted for as part of a life insurance company’s separate account reserves.

If one has an inclination to read more into the first holding of Rev. Rul. 2007-54, and also into its modified holding in Rev. Rul. 2014-7, one might wonder whether the ruling is aimed at answering the question of whether, for a variable contract, the comparison of the FPR to the net surrender value, and then to statutory reserves, is done based on the aggregate FPR for the contract or separately for FPR held in the general account and FPR held in the separate account. I have concluded that assuming Rev. Rul. 2014-7 is aimed at that question is reading too much into it. First, if that were the question to be answered by the ruling, the issue could have been stated a lot more clearly. Second, although the ruling cites both the comparison test of I.R.C. § 807(d)(1), which applies generally, and the separate accounting rules under I.R.C. § 817(c), which apply specifically for variable contracts, the analysis has no discussion of how these provisions might relate to each other. For example, the analysis does not say that the general rule that all FPR for a contract should be aggregated before compared to the net surrender value should override the separate account-

ing provision applicable specifically to variable contracts. Alternatively, the analysis does not explain that the specific separate accounting rule for income, exclusion, deduction, asset, reserve and other liability items that applies to variable contracts essentially requires that the separate account portions of a variable contract be treated as a contract that is issued as part of the separate account business, which under I.R.C. § 817 is accounted for as separate from the general account business. Third, the dollar amounts used in the facts do not allow the holding to illustrate clearly whether the I.R.C. § 807(d) (1) comparison should be done in the aggregate or separately for general and separate account reserves; it appears that the answer would be the same either way. Thus, the holding of Rev. Rul. 2014-7 merely illustrates that when the FPR is greater than the net surrender value, and less than the statutory reserves, the FPR amount is the life insurance reserve amount taken into account under I.R.C. § 807(d) (which is what I.R.C. § 807(d)(1) literally provides). ◀

#### END NOTES

- <sup>1</sup> 2014-9 I.R.B. 539 (Feb. 24, 2014).
- <sup>2</sup> 2007-2 C.B. 604.
- <sup>3</sup> For a discussion about how the company’s share should be computed, see *Proration for Segregated Asset Accounts—How Is the Company’s Share Computed?* 1 *Taxing Times*, Vol. 3, Issue 3 (September 2007); *Proration for Segregated Asset Accounts—Part Two*, 21 *Taxing Times*, Vol. 4, Issue 1 (February 2008).
- <sup>4</sup> 2007-2 C.B. 799.
- <sup>5</sup> In contrast, “revoked” describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling. It is my understanding that Rev. Rul. 2007-54 was not revoked because the IRS did not think the first holding was incorrect. Rev. Rul. 2007-54 was not revoked “in part” (i.e., the second holding) either.
- <sup>6</sup> On May 20, 2010, the IRS issued an IDD, LMSB-4-0510-015, which supersedes all prior directives regarding examining the DRD attributable to separate accounts of life insurance companies. The IDD affirms that Treas. Reg. § 1.801-8(e) sets forth a formula to be used in computing required interest at “another appropriate rate” for reserves accounted for as part of a separate account. It states that agents should consider raising the DRD issue if a life company’s method for computing its company’s share of investment income is inconsistent with I.R.C. § 812 and Treas. Reg. § 1.801-8(e), as illustrated by TAM 200038008 (Jun. 13, 2000) and TAM 200339049 (Aug. 20, 2002).

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## DISTRICT COURT RULES § 4371 EXCISE TAX INAPPLICABLE ON FOREIGN-TO-FOREIGN RETROCESSIONS

By Edward C. Clabault

**O**n Feb. 5, 2014, the U.S. District Court for the District of Columbia granted summary judgment for the plaintiff in *Validus Reinsurance Ltd. v. United States of America*, Civil Action No. 13-0109 (ABJ), and held as a matter of law that the Federal Excise Tax (“FET”) on insurance transactions does not apply to retrocessions.

In this case, Validus Reinsurance Ltd. (“Validus Re”), a Bermuda reinsurer, had reinsured U.S. risks, and then retroceded a portion of those risks to foreign persons not eligible for an FET exemption under a Tax Treaty. The Internal Revenue Service (IRS), pursuant to its position as stated in Rev. Rul. 2008-15,<sup>1</sup> assessed an excise tax of 1 percent on Validus Re for the retrocession. Validus Re paid the tax, and appealed.

Under Internal Revenue Code (“IRC”) § 4371, there is an excise tax of 4 percent that is imposed on each dollar of premium paid on (1) casualty insurance and indemnity bonds and an excise tax of 1 percent on (2) life insurance, sickness and accident policies and annuity contracts. There is also a 1 percent excise tax on reinsurance covering any contracts listed in (1) or (2).

In looking to the plain language of the statute, the Court found that the excise tax statute did not apply to retrocession transactions. The Court noted that the tax imposed on reinsurance transactions only applied to the reinsurance of contracts as defined under IRC § 4371(1) and (2), and would not apply to retrocessions because reinsurance is not listed in (1) or (2). The Court rejected the IRS’ argument that retrocessions should be included under the excise tax statute to effect Congress’ intent of placing U.S. and foreign reinsurers on equal ground (because foreign reinsurers are not subject to U.S. federal income tax). The Court noted that the language of the statute was clear and, therefore, did not look beyond it.

The Court’s ruling in this case calls into question the interpretation of IRC § 4371 put forth by the IRS in Rev. Rul. 2008-15. Specifically, Situation 2 of that ruling contemplates a U.S. insurer that reinsures U.S. risks with Foreign Reinsurer A, which then reinsures those risks with Foreign Reinsurer

B. Neither Foreign Reinsurer A nor Foreign Reinsurer B is eligible for an FET treaty exemption. The revenue ruling concludes that there would be an FET due on both reinsurance transactions. Given the Court’s decision regarding retrocessions, the IRS’ interpretation in this scenario may be in question, with the second of the two transactions being a retrocession not subject to the excise tax.

As part of its motion for summary judgment, Validus Re also raised the argument of whether the FET could apply to an extraterritorial transaction between foreign persons, arguing that the necessary congressional intent for extraterritorial application was not present. Finally, it articulated a constitutional argument, stating that as a matter of due process there must be a “substantial connection” between the United States and the transaction before Congress can tax it, claiming that there is no “substantial connection” in the foreign-to-foreign retrocessions at issue. In basing its decision solely on the plain language of the statute, the Court did not address these other arguments put forward by the plaintiff.

The decision leaves a few additional unanswered questions. For example, in Rev. Rul. 2008-15, Situation 1, a U.S. Corporation insures U.S. risks with Foreign Insurer, which then reinsures those risks with Foreign Reinsurer. Neither Foreign Insurer nor Foreign Reinsurer is eligible for an FET treaty exemption. The ruling concludes that the FET applies to both the direct insurance transaction between U.S. Corporation and Foreign Insurer, and the reinsurance transaction between Foreign Insurer and Foreign Reinsurer. Although the *Validus* decision addresses foreign-to-foreign retrocessions, the treatment of foreign-to-foreign reinsurance transactions similar to that discussed above remains unclear. Also unclear is the application of the excise tax to retrocessions from a U.S. reinsurer to a foreign person. Is this retrocession subject to tax at all? The *Validus* ruling appears to say that such a retrocession would not be subject to excise tax.

As this issue went to press, on April 3 the IRS filed a notice to appeal the *Validus* decision. ◀

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## END NOTES

<sup>1</sup> 2008-12 I.R.B. 633 (2008).

## RENT-A-CENTER, INC. v. COMMISSIONER

By Edward C. Clabault

On Jan. 14, 2014, the Tax Court decided *Rent-A-Center, Inc. and Affiliated Subsidiaries v. Commissioner*, 142 T.C. No. 1 (2014) (“RAC Case” or the “Case”), involving a captive insurance arrangement that was challenged by the Internal Revenue Service (IRS). The Tax Court found that a parental agreement between a captive and its parent could be present in a valid insurance arrangement for federal income tax purposes. The Case also dealt with the manner in which risk distribution is measured in determining the existence of insurance. The taxpayer in the RAC Case was a Texas resident and the case was heard in Texas.

The taxpayer, Rent-A-Center, Inc. (“RAC”), was the parent group of approximately 15 affiliated subsidiaries. RAC, through stores owned and operated by its subsidiaries, rented, sold and delivered home electronics, furniture and appliances. Partly in response to high fees paid to a commercial insurer, RAC formed Legacy, a Bermuda Class I insurer, in 2002 in an effort to lower costs and improve efficiency. From 2003 through 2007, RAC obtained unbundled workers’ compensation, automobile, and general liability insurance from Legacy up to a specified loss limit, and obtained coverage from Discover Re (an unrelated reinsurer) for losses in excess of those insured by Legacy.

RAC was a listed policyholder pursuant to the Legacy policies, but no premiums were attributable to RAC since it did not own stores, have employees or operate vehicles. Rather, RAC

primarily operated through its subsidiaries, to which it would recharge premium expenses. Approximately 60 percent of the risk insured by Legacy was concentrated in one of RAC’s 15 subsidiaries during the years at issue, and approximately 90 percent of the total risk was concentrated in four of its subsidiaries. Legacy received no premiums from unrelated entities from 2002 through 2007.

As part of the Bermuda regulatory requirements, Legacy was required to maintain a specified level of capital. To increase its regulatory capital, Legacy petitioned its regulator for permission to treat its deferred tax assets as general business assets. In 2003, such permission was granted, with the stipulation that Legacy’s parent guarantee its liabilities up to \$25 million. While the guarantee included Legacy’s liabilities under the Bermuda Insurance Act, it did not guarantee Legacy’s general liabilities to unrelated insurers.

The test the Tax Court and the IRS have looked to in determining whether a captive qualifies as an insurance company for federal income tax purposes has three prongs, all of which need to be met: First, does the arrangement involve an insurance risk? Second, are adequate risk shifting and risk distribution present? Third, does the arrangement meet commonly accepted notions of insurance? Factors that have been considered in performing these analyses include whether the company is adequately capitalized and whether the captive company was formed for a valid nontax reason.

Noting that the IRS conceded that the policies issued by Legacy involved insurance risk, the Tax Court next examined whether the transaction met the risk shifting and risk distribution requirements. In determining that Legacy’s policies shifted risk, the Tax Court focused on the arrangement’s economic impact on RAC’s subsidiaries, noting that the RAC subsidiaries’ balance sheets would be unaffected in the event of an insured loss (which some commentators refer to as the “balance sheet test”). As highlighted in the dissent, an approach that assumes risk shifting can be present in brother-sister arrangements constitutes a departure from the Tax Court’s prior position on this issue, as articulated in *Humana*.<sup>1</sup> Although its *Humana* position was reversed on appeal, this is the first time the Tax Court has acknowledged the existence of risk shifting in a brother-sister arrangement.

The Tax Court also found that the parental agreement between RAC and Legacy did not prevent the subsidiaries from

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shifting risk to the captive, noting that the parental guarantee did not affect the balance sheet test—the affiliates’ balance sheets were protected whether or not the parental guarantee was in place. The Tax Court’s decision in the RAC Case goes further than its decision in *Hospital Corp of America*, where the Tax Court found that the presence of a parental indemnity agreement that related to only a small portion of the captive’s policies was not sufficient grounds to invalidate an otherwise bona fide insurance transaction.<sup>2</sup> In that case, the court disallowed the premium deduction based on a lack of risk shifting, but limited the disallowance to the portion of the coverage that was potentially subject to the parental indemnity agreement. The Tax Court distinguished several earlier cases that found that captive arrangements involving parental guarantees did not constitute insurance for federal income tax purposes.<sup>3</sup> In those cases, the captives were found to be undercapitalized and to have required guarantees at the behest of third-party insurers.

In finding that risk distribution was present, the Tax Court’s analysis in the RAC Case focused on the number of risks at issue, not the number of legal entities taking part in the insurance arrangement. Further, in its risk distribution analysis, the Tax Court did not express concern with the concentration of risk in each entity (as noted above, one entity had over 60 percent of the total risk). As such, it did not find it necessary to rely on the safe harbor outlined in Rev. Rul. 2002-90, in which the IRS held that 12 subsidiaries, none with more than 15 percent of the total insured risks, were sufficient for finding risk distribution.<sup>4</sup>

The Tax Court’s approach in the RAC Case stands in stark contrast to the IRS’ position as described in Rev. Rul. 2005-40.<sup>5</sup> In concluding that risk distribution was not present, Rev. Rul. 2005-40 focused on the fact that one or two legal entities taking part in the arrangement—as opposed to the 12 subsidiaries under the Rev. Rul. 2002-90 safe harbor—were insufficient for risk distribution; in doing so, the revenue ruling ignored the presence of “a significant volume of independent, homogeneous risks.”

The IRS has never articulated its rationale for determining risk distribution based on the number of insureds. That position, however, stands in contrast to general insurance principles, under which risk distribution, based on the law of large numbers, focuses on the number of independent risks rather than the number of insureds.

In reaching its conclusion that risk distribution was present in the RAC Case, the Tax Court noted that Legacy insured three types of risk: workers’ compensation, automobile and general liability. Additionally, the Tax Court noted that during 2003 to 2007, RAC’s subsidiaries owned between 2,623 and 3,081 stores, had between 14,300 and 19,740 employees, operated between 7,143 and 8,027 insured vehicles, and operated stores in all 50 states. The Tax Court made no mention of the number of legal entities insured as part of its analysis. The holding is significant because it provides further indication that the Tax Court views risk distribution based on general insurance principles, looking at the number of independent risks, rather than based on the IRS’ “number of legal entities” approach, as outlined in Rev. Rul. 2002-90 and Rev. Rul. 2005-40. The RAC Case’s rationale for risk distribution follows the approach found in *Gulf Oil*, where risk distribution was not dependent on the number of insured entities, and it was noted that “a single insured can have sufficient unrelated risks to achieve adequate risk distribution.”<sup>6</sup>

The IRS has challenged numerous captive insurance arrangements involving one or a limited number of insureds—e.g., in cases involving protected cell companies and situations involving single member limited liability companies that are looked through for tax purposes—on risk distribution grounds. It is not clear whether the real concern of the IRS in those situations is actually one of risk transfer, and not risk distribution. While such a position would be rebuttable as well, a risk distribution analysis, which by definition is based on large numbers of independent risks, does not require that the number of legal entities insured be taken into consideration.

As of the time of this writing, the IRS had not indicated whether it will revisit its approach in Rev. Rul. 2002-90 and Rev. Rul. 2005-40, which focus on the number of insured entities, and focus instead on the number of independent risks in determining if a captive insurance arrangement has adequate risk distribution. The IRS has also not indicated whether the RAC Case could result in a different approach to parental guarantees and their role in invalidating captive insurance arrangements. The Case suggests that parental guarantees might not impact captive arrangements as long as the insured subsidiary’s balance sheet is protected and the captive is adequately capitalized.

Also as of the time of this writing, the IRS had not indicated whether it would acquiesce to the Tax Court’s decision. It is worth noting that this case was reviewed by all the judges from the Tax Court, with seven in favor of RAC, four concurring



in the result, and six dissenting. Any appeal would be heard by the 5th Circuit Court of Appeals. Assuming the facts cited are uncontested, to reverse the decision the Court of Appeals would need to find the Tax Court's legal determination "clearly erroneous." ◀

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#### END NOTES

- <sup>1</sup> *Humana Inc. & Subs. v. Commissioner*, 881 F.2d 247, 248 (6th Cir. 1989), *aff'g in part, rev'g in part and remanding* 88 T.C. 197 (1987).
- <sup>2</sup> See *Hospital Corp. of America v. Comm'r*, T.C. Memo 1997-482 (1997).
- <sup>3</sup> See *Malone & Hyde, v. Comm'r*, 62 F.3d 835 (6th Cir. 1995); *Carnation v Comm'r*, 71 T.C. 400 (1978); and *Kidde v. United States*, 40 Fed. Cl. 42 (1997).
- <sup>4</sup> 2002-52 I.R.B. 985 (Dec. 30, 2002).
- <sup>5</sup> 2005-24 I.R.B. 4 (July 5, 2005).
- <sup>6</sup> *Gulf Oil Corp. v. Comm'r*, 89 T.C. at 1010, 1026, (1987) (dictum), *rev'd in part on other grounds*, 914 F.2d 396 (3d Cir. 1990).

## SUBCHAPTER L: CAN YOU BELIEVE IT? LIFE INSURANCE RESERVES NEED NOT ALWAYS BE "LIFE INSURANCE RESERVES"

By Peter H. Winslow

The Internal Revenue Code (the "Code") permits life insurance companies to deduct on a reserve basis six categories of "items" listed in I.R.C. § 807(c). The first item is "life insurance reserves (as defined in section 816(b))." In general, I.R.C. § 816(b) limits the definition of "life insurance reserves" to amounts that are set aside on the annual statement for future unaccrued claims under life insurance, annuity, and noncancellable accident and health insurance contracts, and are computed or estimated on the basis of

recognized mortality or morbidity tables and assumed rates of interest. Thus, on its face the Code could be read to condition the deduction for reserves with respect to the designated types of contracts on satisfaction of computational requirements for statutory reserves. As explained below, this is not what the cross-reference to I.R.C. § 816(b) in the list of deductible reserves really means. Instead, Congress intended that statutory reserves for future unaccrued claims under the types of contracts specified in I.R.C. § 816(b) should be deducted as life insurance reserves subject to I.R.C. § 807(d) whether or not they flunk the computational requirements for life insurance reserves in I.R.C. § 816(b).

This apparent inconsistency in the treatment of life insurance reserves is a result of the addition of I.R.C. § 807(d) in the Deficit Reduction Act of 1984 (the "1984 Act"). Under I.R.C. § 807(d), for purposes of determining the deduction or income from changes in tax reserves, "life insurance reserves" are required to be recomputed using the National Association of Insurance Commissioners (NAIC) prescribed method applicable for the type of contract and specified interest and mortality or morbidity assumptions. The drafters of I.R.C. § 807(d) understood that the cross-reference to the I.R.C. § 816(b) definition of life insurance reserves in the listing of deductible reserves created an ambiguity as to the treatment of non-qualifying statutory reserves. Can the company argue that the statutory reserves are deductible in full as another I.R.C. § 807(c) item and avoid the I.R.C. § 807(d) rules by intentionally establishing statutory reserves that do not satisfy the I.R.C. § 816(b) computational requirements? Can the Internal Revenue Service (IRS) argue in these circumstances that no reserve deduction at all is available? The legislative history to the 1984 Act answers these questions as follows:

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in present law required proper computation under State law in order for deductions to be allowed, because present

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law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The bill, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves.<sup>1</sup>

This legislative history resolves the ambiguity in the statute created by the cross-reference to I.R.C. § 816(b) by clarifying that statutory reserves that could have been computed to qualify as life insurance reserves are required (not merely permitted) to be recomputed in accordance with I.R.C. § 807(d).

The backdrop of this clarification in the legislative history is the many disputes that arose under pre-1984 Act law on the consequences of failure of a reserve to qualify as a life insurance reserve. In prior law's three-phase system of tax, treatment of a reserve as a life insurance reserve could make a significant difference to so-called "Phase I companies" subject to tax on only their taxable investment income. The portion of net investment income considered added to life insurance reserves reduced the company's taxable investment income. Qualification as life insurance reserves was not determinative as to whether the reserves were deductible in gain from operations (Phase II). For this reason, IRS rulings dealing with life insurance reserves under pre-1984 Act law generally dealt solely with the life insurance reserve classification issue and not with the question of whether the non-qualifying reserves were deductible.

In audits, IRS agents who proposed to disallow reserves as life insurance reserves did not always disallow a deduction in Phase II gain from operations for the increase in reserves. And, if Exam did propose a deduction disallowance based solely on computational issues, Appeals Officers usually permitted the non-qualifying reserves to be deducted as unearned premium reserves (now classified as deductible reserves in I.R.C. § 807(c)(2)).

Several examples can illustrate the disputes that occurred under prior law that the 1984 Act legislative history sought to resolve. In Rev. Rul. 69-302,<sup>2</sup> the IRS ruled that gross unearned premium reserves for decreasing term credit life insurance policies computed using a sum-of-the-year-digits method did not qualify as life insurance reserves because they were not actuarially computed or estimated on the basis of recognized mortality tables and assumed rates of interest. The

IRS' position was rejected in *Central National Life Insurance Co. of Omaha v. United States*,<sup>3</sup> because the court concluded that the gross unearned premium reserves were a reasonable estimate of tabular discounted reserves. This question of when a gross premium reserve was a proper estimate of a tabular discounted reserve was unresolved at the time the 1984 Act was being considered.

Congress resolved this issue in the 1984 Act, and the credit life reserve deduction dispute would not occur under current law. The gross unearned premium reserves would be recomputed under I.R.C. § 807(d) as the higher of net premium reserves using CRVM or the net surrender value, which in the case of credit life insurance would be the refundable portion of the gross premium in the event of termination of the policy.<sup>4</sup> Thus, the conclusion in Rev. Rul. 69-302 no longer is relevant for purposes of determining whether the reserve is deductible, and in what amount. It is notable that in this situation I.R.C. § 807(d), in effect, permits a deduction for gross unearned premium reserves as life insurance reserves if they qualify as net surrender values and exceed net premium CRVM reserves.

Although Congress decided to resolve the pre-1984 Act disputes as to the deductibility of reserves, it did not eliminate the disputes as they relate to the classification of the company as a life or nonlife insurance company. To be taxed as a life insurance company, more than 50 percent of the total statutory reserves still must be life insurance reserves that satisfy the I.R.C. § 816(b) definition (including the computational requirements) or unearned premiums and unpaid losses on noncancellable life, accident or health policies not included in life insurance reserves. The unexpressed, behind-the-scenes reason Congress did not clarify the definition of life insurance reserves for purposes of life company qualification was a desire to avoid causing companies to have their tax classification as a life or nonlife company shifted by reason of the adoption of the 1984 Act. It is evident that the IRS and Treasury sometimes wish that Congress had adopted a different approach and clarified that life insurance reserves do not need to satisfy the outdated computational requirements of I.R.C. § 816(b) to be included in the numerator under the 50 percent reserve ratio test. For example, if adopted, Proposed Treasury Regulations § 1.801-4(g) would override many pre-1984 Act IRS rulings and case law to provide that, if an insurance company does not compute or estimate statutory reserves using mortality or morbidity tables and assumed rates of interest, then either the taxpayer or the Commissioner may recompute the reserves to satisfy the requirements of I.R.C. § 816(b). Similarly, in Notice 2008-18, section 3.01,<sup>5</sup> the IRS stated that it may publish guidance to pre-

vent the adoption of principle-based reserves and what became Actuarial Guideline 43 from causing a company to be reclassified as a nonlife insurance company subject to tax under Part II of Subchapter L, instead of Part I applicable to life companies. These proposed regulations and notice further underscore that the computational requirements of I.R.C. § 816(b) should not be considered a prerequisite to a tax reserve deduction.

Let's take another example of an issue that arose under prior law. In a series of unpublished private rulings, the IRS adopted the position that substandard extra reserves on life insurance policies did not qualify as life insurance reserves unless they were actuarially computed. According to the IRS, a substandard extra reserve computed as a percentage of the extra gross premium charged the policyholder did not qualify, but an extra reserve computed by factors that grouped the substandard policies by age groups, policy duration, and plan of insurance, and used ratios that approximated the greater mortality by rating class did qualify. Under current law, it does not matter whether the substandard extra statutory reserves qualify as life insurance reserves. Under I.R.C. § 807(d)(5), the reserves are required to be calculated using the specified standard mortality table "adjusted as appropriate" for the non-standard risks. The deduction issues under current law are limited to whether the risks are non-standard and, if so, what adjustment to the standard table is appropriate.

Another example helps illustrate how the statute works. Under pre-1984 Act law, many disputes arose as to whether disability disabled-lives reserves qualified as life insurance reserves. One type of disability disabled-lives reserves arose under group life insurance policies as a waiver-of-premium benefit in the event of an insured's disablement. Many companies held disability waiver-of-premium reserves using a rule-of-thumb equal to 75 percent of the face amount of insurance in force. This again raised the issue as to whether reserves were properly estimated. In *Group Life & Health Insurance Co. v. United States*,<sup>6</sup> a district court held that these reserves qualified as life insurance reserves because they were based on a Society of Actuaries (SOA) study that considered mortality and interest rates. On appeal, the Fifth Circuit reversed, finding that the company itself had not made its own actuarial estimates in adopting the SOA's rule-of-thumb reserve method. Under current law, this dispute would be relevant only for life insurance company qualification under I.R.C. § 816(b), not for reserve deduction purposes. As reserves for supplemental benefits under I.R.C. § 807(e)(3), the statutory reserves would be deductible in full whether or not they are considered to be computed

or estimated using recognized mortality or morbidity tables and assumed rates of interest under I.R.C. § 816(b).

The legislative history explaining how the statute was intended to work has important implications as to the deductibility of reserves in the event the NAIC-adopted principle-based reserves standard becomes operative. Two observations are critical. First, Congress intended the I.R.C. § 807(d) tax reserve computation rules to apply to all reserves held for future unaccrued claims under life insurance, annuity, and noncancellable accident and health insurance contracts regardless of how statutory reserves are computed. Second, in adopting I.R.C. § 807(d), Congress did not have a conceptual problem with allowing a deduction for at least some types of reserves that are computed in a way that fails to satisfy the technical requirements of I.R.C. § 816(b). For example, Congress understood that gross unearned premium reserves and statutory rule-of-thumb reserves for supplemental benefits would be deductible as life insurance reserves under I.R.C. § 807(d) regardless of the cross-reference to I.R.C. § 816(b).

What this means, to this commentator at least, is that, if the NAIC prescribes new methods of computing minimum reserves that become operative, I.R.C. § 807(d)'s deference to the NAIC method for tax reserves would require that method to be used for deduction purposes for newly issued contracts regardless of whether the resulting reserves would be considered to qualify as life insurance reserves under I.R.C. § 816(b).<sup>7</sup> In other words, under Subchapter L, as amended by the 1984 Act, it may not matter for deduction purposes whether life insurance reserves are life insurance reserves. ◀

#### END NOTES

- <sup>1</sup> S. Rep. No. 98-169, pt. 1 at 539-40 (1984); H.R. Rep. No. 98-432, pt. 2 at 1414 (1983).
- <sup>2</sup> 1969-1 C.B. 186.
- <sup>3</sup> 574 F.2d 1067 (Ct. Cl. 1978).
- <sup>4</sup> In contrast to I.R.C. § 807(d), for purposes of the cash value accumulation test in I.R.C. § 7702(b) for qualification as a life insurance contract, the refundable portion of the gross unearned premium of a credit life insurance policy is not included in the cash surrender value because it is not subject to policy loan borrowing. S. Rep. No. 98-169, pt. 1 at 573 (1984).
- <sup>5</sup> I.R.B. 2008-5 (Jan. 14, 2008).
- <sup>6</sup> 42 AFTR 2d 78-6282 (N.D. Tx. 1978), rev'd 660 F.2d 1042 (5th Cir. 1981).
- <sup>7</sup> *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir. 2012).

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