

Taxing TIMES

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VARIABLE ANNUITY HEDGING DIRECTIVE – A LONG AND WINDING ROAD

By Eric Bisighini and Tim Branch

“Patience and perseverance have a magical effect before which difficulties disappear and obstacles vanish.”¹

— John Quincy Adams

In the fall of 2010, the life insurance industry and the IRS began the Industry Issue Resolution (IIR) process regarding the recognition of hedging gains and losses for guaranteed benefits on variable annuity (VA) contracts. On July 18, 2014, the IRS published “I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies (LB&I-04-0514-0050)” (the Directive) which provides a safe harbor treatment for variable annuity hedging gains and losses relating to VA contracts issued before Dec. 31, 2009. The Directive addresses, at least in part, a major audit issue, similar to the §166 Partial Worthlessness Directive issued in 2012.²

The Directive instructs the Large Business & International (LB&I) division’s examiners to not challenge for certain hedges the qualification of an insurance company’s hedging transactions, the mark-to-market (MTM) values of eligible hedges (if they conform to the amounts reported in the Annual Statement) or the method of accounting for income, deductions, gains or losses. The intent of the Directive is to provide “an efficient and uniform method of accounting” for certain GMxB hedges and “allow LB&I and taxpayers to more efficiently manage their audit resources.”³ While the Directive is intended to provide financial statement and tax return certainty for a company’s tax position relative to certain hedges

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David Schraub

Staff Partner

e: dschraub@soa.org

Anna Matras

Graphic Designer

Kathryn Baker

Staff Editor

e: kbaker@soa.org

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FROM THE EDITOR TO OUR READERS

By Kristin Norberg

Welcome, readers! This has been an active year for the Taxation Section and for *TAXING TIMES*. Our volunteers have had a busy time executing the section's objective to provide timely and relevant information about items of tax and actuarial interest to Taxation Section members and other interested parties.

Along with several court cases and IRS rulings, two significant events happened in the tax actuarial space during 2014: the release in February of a comprehensive tax reform discussion draft (the Discussion Draft) from House Ways and Means Committee Chairman Dave Camp (R-MI), and the long-anticipated IRS guidance to examiners (the Directive) released in late July on hedging of variable annuity guaranteed benefits. *TAXING TIMES* is addressing both of these events this fall. In this issue, Eric Bisighini and Tim Branch have written our lead article discussing the history and content of the Directive, which arose from a nearly four-year-long Industry Issue Resolution process. In the *TAXING TIMES Supplement* that accompanies this issue, we have presented an in-depth analysis of the Discussion Draft's proposed reforms affecting the insurance industry, authored by about a dozen Taxation Section members, affiliates and colleagues.

Both the Discussion Draft and the Directive have reminded me of three things:

First, on major pieces such as these, there is often a variety of opinions, arising from a diversity of company situations and professional interpretations. Our editorial board review process was quite extensive and thought-provoking as our authors and editors worked through these diverse opinions. The final articles presented are the work of each author and do not necessarily represent the opinions of the Society of Actuaries, the Taxation Section, or our firms and organizations, but the authors have striven to take into consideration the alternative viewpoints presented to them. We welcome letters to the editor to continue the conversations.

Second, actuaries cannot work in a vacuum—and neither can non-actuary tax professionals. It takes multi-disciplinary collaboration to analyze these documents, understand the potential impacts on the insurance industry or on a particular company, and develop appropriate responses. Our strong affiliate membership (i.e., non-SOA members) in the Taxation Section helps make this possible.

Third, *TAXING TIMES* is a massive effort—and many hands make light(er) work. Thank you to everyone involved for giving your time and expertise to the objectives of the section, and thanks also to the SOA for accommodating us. Along these lines, I'm also pleased to welcome several first-time contributors to *TAXING TIMES*, in both this main issue and the supplement.

Enjoy the discussions!

Note: Our new feature, "In the Beginning... A Column Devoted to Tax Basics," will return in the next issue of *TAXING TIMES*. If you would like to submit a question or suggestion for a future column, please email the editor at kristin.norberg@ey.com.

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FROM THE CHAIR

10 YEARS STRONG

By Brenna Gardino

The past year has gone very quickly and it is hard to believe that this “From the Chair” column is my last. The Taxation Section celebrates its tenth anniversary this year and I believe this milestone merits a moment of reflection.

DECADE IN REVIEW

The Taxation Section began in 2004 as a forum for those with tax expertise to discuss common interests and challenges. The founding members were:

Chair:	Ed Robbins
Vice Chair:	Barbara Gold
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Council Members:	Bud Friedstat, Doug Hertz, Brian King, Pete Marion, Art Panighetti, and Jim Reiskytl
Newsletter Editor:	Brian King
Assistant Editor:	Christine Del Vaglio
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Interestingly, since the founding of the section, two of the original people involved (Bruce Schobel and Ed Robbins) went on to be Presidents of the SOA. Over the years, several council members have subsequently served on the SOA Board (Bud Friedstat and Kory Olsen) and the council has also been fortunate to have prior SOA Board members subsequently serve on the council (Chris DesRochers and Jim Reiskytl). I mention this because I am proud (and a bit in awe) of the high-caliber expertise and leadership that the Taxation Section has both contributed and benefited from.

Over the years, the section has built a reputation of top-notch technical skill combined with industry and tax-specific knowledge. These skills and knowledge have undoubtedly had an impact on the industry and will continue to long into the

future. The section’s strong reputation and access to valuable resources (such as *TAXING TIMES*) has steadily attracted new members. Over the last decade, the section has grown to over 800 members and members of this section report one of the highest levels of satisfaction overall with the SOA. Meeting sessions that are sponsored by the Taxation Section are always highly rated (sessions at this year’s Life and Annuity symposium received some 5s!). The past decade has been an accomplishment.

YEAR IN REVIEW

My top priority for the past year has been the recruitment and development of the next generation of tax actuaries. After a decade of success, it is a natural progression for the section to begin reaching out to entry-level members to expand the knowledge base that exists. This expansion prepares the section for future demand and enables current members to create a legacy.

As part of this effort, the section has recently sponsored basic education sessions at SOA meetings. The Life and Annuity Symposium in May had very strong content for beginner tax actuaries and these sessions were well-attended and well-rated. The Product Tax Seminar and Boot Camp in September provided another opportunity and educational forum for members looking to increase their knowledge.

The Taxation Section also presented at the Chicago Actuarial Club in the spring and the Kansas City Actuarial Club in July. The message to increase volunteerism is spreading through grass root efforts and the Taxation Section is a key part of that. The past year has provided valuable groundwork for the section to expand its membership and further develop its newer members.

THANK YOU!

I believe the Taxation Section is made up of very special people and has particularly active and high-performing council members and friends of the council. I would like to thank each of these council members and friends of the council for their help and support this past year.

There are also a few people in particular that I owe special thanks. Kristin Norberg—thank you for your outstanding volunteer work this past year! Kristin has played a key role in the sub-committee that has focused on the attraction and development of the next generation of tax actuaries and has also stepped into a new role with *TAXING TIMES*. I appreciate Kristin's leadership and willingness to help. Jim Van Etten—thank you for your extra efforts these past two years as Secretary/Treasurer. You have done a great job at keeping the section organized, documented and financially sound. Meg Weber and Christy Cook—thank you for all the little (and big!) items that you have helped with the past few years. Your responsiveness and words of wisdom have been helpful. You both have been a pleasure to work with!

As always, tax topics continue to be critical issues and the future will bring both opportunities and challenges. I strongly believe the Taxation Section will continue to build on its prior 10 years of success by providing relevant expertise and leadership...for many decades into the future. ◀

Brenna Gardino, FSA, MAAA, is assistant vice president and associate actuary, product management at Kansas City Life Insurance Company. She may be reached at bgardino@kclife.com.

of guaranteed benefits addressed in the Directive, some questions remain for those guaranteed benefit hedges specifically not addressed in the Directive.

BACKGROUND ON VARIABLE ANNUITY HEDGING

What is variable annuity hedging, and how did it become such a big issue for life insurance companies? Life insurers began offering enhanced guarantees for variable annuity contracts in the early 2000s, especially guaranteed minimum living benefits (GMLBs), in addition to the existing death benefit guarantees (GMDBs). Guaranteed minimum death and living benefits are collectively known as GMxBs.

The most common GMDB provides a death benefit equal to the greater of the account value or the premium contributions to the variable annuity, also known as a return of premium (ROP). Later variations included a GMDB that was based on the higher of the ROP or the maximum account value (MAV) at a particular date, typically the contractholders' policy anniversary date, or a guaranteed "roll-up" amount at a specified interest rate.

There are a number of different types of living benefit guarantees that may be offered with the variable annuity. For purposes of this article, we will focus on only three of these living benefits—guaranteed minimum withdrawal benefits (GMWBs), guaranteed minimum income benefits (GMIBs) and guaranteed minimum accumulation benefits (GMABs). These living benefits introduced additional market and policyholder behavior risk to VA contracts because the contract holders could withdraw or annuitize certain amounts under the variable annuity during their lifetime at points in time that are considered adverse from the insurer's perspective.

The GMWB allows the contract holder to withdraw a certain percentage of their guaranteed principal balance (GPB) each year, regardless of whether the account value is less than the GPB. The withdrawals are subject to annual percentage limitations, generally ranging from four percent to seven percent of the GPB each year depending on issuer, and often specified dates for electing these withdrawals. The GMIB provides the contractholder with guaranteed payout amounts in the future, even if the account value does not support the guaranteed benefit. The GMAB provides the contractholder with a guaranteed minimum account value on a specified date, regardless of the market performance of the investments.

The addition of GMxBs to VA contracts increases an insurance company's market risk exposure, since the guaranteed benefits are directly related to underlying investments. Market risks include changes in equity markets, interest rates, foreign currency, etc., and the impact on the underlying separate accounts of the VA. The guaranteed benefit can be viewed as an embedded option owned by the contractholder; when markets decline, the value of the guarantee increases and the embedded option is "in the money" (ITM). The opposite is true when the markets increase. Life insurance companies developed hedging programs to manage these additional market risks in order to meet their obligations for VA guarantees.

Life insurance companies use investment derivatives in their hedging programs because of the flexibility and liquidity of the derivative markets. Derivatives can have either a direct or inverse relationship with the underlying investment index. For example, many hedging programs use equity "put options" that appreciate in value during a stock market downturn, but depreciate, or expire worthless if the S&P 500 stock index goes up. These put options appreciated substantially during the "Great Recession" of 2008-2009, but lost value in the 2009-2010 recovery, and more recently during the strong "bull market" of 2013.

There are many different types of derivatives used to manage the risks with respect to GMxB, including but not limited to equity options, futures or forward contracts, interest rate swaps and total return swaps. The derivative contracts may be either traded on a regulated exchange (e.g., S&P futures), or traded over-the-counter (OTC) and negotiated between the insurance company and an investment bank. Derivatives also vary in their maturities, ranging from three-month futures contracts to five-year through 30-year durations for OTC options and interest rate swaps.

Hedging programs are often designed to move in the opposite direction of insurance liabilities for the VA guarantees. When the S&P 500 stock index declined by over 50 percent in 2008 and early 2009, many VA guarantees were considered to be ITM since the policyholder account values were significantly less than the guaranteed amounts under the VA contracts. In this case, hedging gains from put options help offset the increase in reserve liabilities for GMxB, and allowed the insurance company to maintain the required statutory surplus for the variable annuity product.

BOOK TREATMENT FOR HEDGE GAINS AND LOSSES

Most GMxB hedges do not qualify for GAAP hedge accounting under FAS 133 (a.k.a. ASC 815) because FAS 133 requires detailed documentation and “hedge effectiveness” testing. Although most companies can design a FAS 133 test that measures the high degree of correlation between the GMxB hedge and capital market risks, they often do not meet the FAS 133 standard of a “highly effective” test that measures actuarial assumptions and policy holder behavior. The GMxB liability may also be treated as an “embedded” derivative for GAAP. Since FAS 133 does not allow hedge accounting if you are hedging a derivative (i.e., an embedded derivative) with another derivative, GMxB hedge gains and losses are generally required to be mark-to-market (MTM) through the income statement. The GMxB liability for the embedded derivative is also MTM through the income statement under FAS 157.

For U.S. statutory purposes, GMxB hedges are accounted for under SSAP 86. Although Paragraph 7 of SSAP 86 defines a hedging transaction broadly in a manner comparable to I.R.C. §1221(b)(2), SSAP 86 has similar FAS 133 hedge effectiveness testing requirements that do not allow hedge accounting for statutory reporting. Accordingly, the GMxB unrealized hedge gains and losses are recognized on MTM basis through statutory surplus.

TAX TREATMENT OF HEDGE GAINS AND LOSSES

In order to qualify as a hedging transaction for tax purposes, a hedge must be (1) entered into in the ordinary course of business, (2) used to manage the risk of price changes with respect to ordinary property, and (3) clearly identified in the taxpayer’s books and records on the day the hedge is created (I.R.C. §1221(b)(2)).

Under the Directive, a hedge of GMxB liability is a qualified tax hedge if it qualified as a hedging transaction under Treas. Reg. §1.1221-2(b) and the identification of GMxB obligations as “ordinary obligations” is made under Treas. Reg. §1.1221-2(c). Tax hedge treatment is important to insurance companies because hedge gains and losses are taxed as ordinary income, and not as capital gains and losses. Ordinary treatment is preferred, since capital losses can only offset capital gains and can only be carried back three-years or carried forward five-years, whereas ordinary losses can offset either capital or ordinary gains and can be carried back three years or carried forward 15 years for a life insurance company before expiring. Tax hedge accounting also allows the company to match the timing of the



GMxB hedge gain or loss with the timing of the item being hedged (i.e., the liability for the GMxB).

Historically there has been a diversity of practice in how insurance companies accounted for VA hedge gains and losses pursuant to IRS Regulation §1.446-4. For example, some companies used one method for VA hedge gains and another method for VA hedge losses, while other companies spread the net hedge gain or loss over different amortization periods.

GMxB HEDGE ACCOUNTING UNDER THE DIRECTIVE

Pursuant to the Directive, all the GMxB hedges are aggregated. All hedge gains and losses are then netted for the current year and allocated between VA contracts issued before Dec. 31, 2009, and those issued on or after Dec. 31, 2009. Net hedge gains for contracts issued before Dec. 31, 2009, are recognized up to the amount of the net tax deduction for the year (where the net tax deduction is the amount of GMxB accrued plus (or minus) the increase (or decrease) in tax reserves held for the GMxB). Net hedge losses for those contracts, on the other hand, are deducted on a MTM basis, except to the extent of tax reserve increases for GMxBs in the current year. In either case, excess hedge gains or losses for the current year are then carried forward to the subsequent year.

One reason for the different tax treatment of hedge gains and losses is due to the asymmetric relationship between hedging and tax reserves. For example, in a market “crash,” similar to 2008, there were significant hedge gains that were partially offset by increases in GMxB tax reserves. But in a rising market,

CONTINUED ON PAGE 8

such as 2010 through 2013, companies' VA hedges may generate significant hedge losses each period, but the corresponding decreases in tax reserves may begin to taper-off because the account values are much higher than the guaranteed amounts - i.e., the guarantees are "out-of-the-money" (OTM). Tax reserves can never decrease below zero and are always capped by statutory reserves.

The Directive does not provide detailed guidance for accounting for hedge gains and losses allocable to VA contracts issued on or after Dec. 31, 2009, other than that they "should be accounted for using a method consistent with the matching requirements in Treas. Reg. § 1.446-4(e)(1),"⁴ which requires "the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged."⁵

The main tax distinction between contracts issued pre- and post- Dec. 31, 2009 is that the tax reserves for VA contracts issued on or after Dec. 31, 2009 are determined under AG 43 and are subject to the safe harbor outlined in IRS Notice 2010-29, which specifies the Standard Scenario Amount (SSA) under AG 43 as the appropriate Federally prescribed tax reserve (the Federally prescribed tax reserves for pre-Dec. 31, 2009 contracts is discussed in more detail below).

The Directive provides a safe harbor method of accounting for hedge gains and losses allocable to VA contracts issued before Dec. 31, 2009, as long as the following requirements are met:

- GMxB obligations must be identified as "ordinary obligations" under Treas. Reg. § 1.1221-2(c)(2), and GMxB hedges must qualify as hedging transactions under Treas. Reg. § 1.1221-2(b).
- MTM values of GMxB hedges must conform to the values reported in the Annual Statement.
- Eligible GMxB hedges must be allocated between contracts issued before Dec. 31, 2009 and contracts issued on or after Dec. 31, 2009 using a "reasonable method." However, no guidance is provided in the Directive as to what constitutes a reasonable method.
- Method of accounting for pre-Dec. 31, 2009 contracts, as allocated according to the previous requirement, must include four specific steps.

The four steps required for pre-Dec. 31, 2009 contracts are as follows:

- **Step 1: MTM Valuation of Eligible GMxB Hedges**

Under the Directive, the total net MTM change is calculated for all GMxB hedges for the year. The MTM values must be based on the derivative market values in the Annual Statement (or audited financial statement, if appropriate). Companies must also certify the GMxB derivative values are the same as the MTM values in the Annual Statements.

The periodic (swap) payments or receipts for all GMxB hedges are then included with the net MTM hedge gain or loss to equal the Total MTM GMxB hedge gain or loss for the year. Periodic payments do not include the upfront cost for the GMxB hedge (e.g., option premium), and such payments are treated as part of the derivative cost basis.

- **Step 2: Aggregate Net Hedge Gain or Loss on all GMxB Hedges**

The MTM change is calculated for all GMxB hedges in the aggregate to minimize complexity, and reflects the fact that VA hedging is not done on a contract-by-contract basis. This step not only aggregates hedge gains and losses, it also aggregates the different hedge positions and derivatives used, which can vary by product or cohort year.

- **Step 3: Allocate Aggregate Net Hedge Gain or Loss**

The net MTM hedge gain or loss is then allocated between VA contracts issued before and after Dec. 31, 2009 (i.e., the date AG 43 became the tax reserving method) based on a reasonable allocation. The allocation must be "any reasonable method consistently used by an insurance company." The hedge gain or loss allocated to VA contracts issued on or after Dec. 31, 2009, is also required to be consistent with the matching requirements of Treas. Reg. § 1.446-4(e)(1). The Directive's instructions specify "any reasonable method" may be used to allocate hedge gains and losses between VA contracts issued before Dec. 31, 2009, and contracts issued on or after Dec. 31, 2009; implying the IRS may accept more than one method.

- **Step 4: Compute the net tax deduction for the year relating to the GMxB.**

Net GMxB tax deduction is equal to amount of accrued GMxB claims during the year plus (or minus) the increase (or decrease) in tax reserves for GMxB for the year, but not less than zero. Even if the company only partially hedges the GMxB, the full increase in tax reserves and accrued benefits for all GMxB are taken into account. It is provided that companies should use the current year's change in GMxB tax reserves, rather than using cumulative GMxB tax reserves.

Tax reserve methodology is determined by the Commissioners' Annuities Reserve Valuation Methodology (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC) in effect at the contract's issue date. For VA contracts issued before Dec. 31, 2009, the CARVM in effect is interpreted by various Actuarial Guidelines (AG), specifically AG 33 ("Determining CARVM Reserves for Annuity Contracts with Elective Benefits"), AG34 ("Variable Annuity Guaranteed Minimum Death Benefit Reserves") and AG 39 ("Reserves for Variable Annuities with Guaranteed Living Benefits").

There is some question as to the appropriate tax reserve method for GLB's issued before Dec. 31, 2009 (see the *TAXING TIMES* articles "How Are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?" (May 2011, Volume 7, Issue 2), and "Is There Another Tax Reserves Solution for Pre-2010 Variable Annuities?" (October 2013, Volume 9, Issue 3), for more background on this topic). However, the Directive does not offer any details or guidance as to what are appropriate tax reserves.

The hedge accounting safe harbor outlined in the Directive only applies to VA contracts issued before Dec. 31, 2009, and depends on whether there is a net hedge gain or net hedge loss for the year, as follows:

Step 4.a.) If a Net GMxB Hedge Gain for the Year

Under the Directive, VA hedge gains are recognized to the extent of the net tax deduction for the year relating to the GMxB in Step 4. Any excess net hedge gains for the year are carried forward and treated as hedge gains in the succeeding year. Any deferred hedge gains not taken into account within five years after the year the gains arise, are

recognized no more slowly than ratably over the succeeding five years.

The recognition of VA hedge gains under the Directive potentially avoids recognizing excess hedge gains in an economic crisis such as 2008-2009.

Step 4.b.) If a Net GMxB Hedge Loss for the Year

On the other hand, the net hedge losses for the year (after reduction for any deferred hedge gains from preceding years, or including any net hedge losses, carried forward from preceding years) are recognized for tax purposes on a MTM basis, except to extent there is an increase in GMxB tax reserves for the current year in Step 4. Any excess hedge losses are then carried forward and treated as hedge losses in the succeeding year. If the deferred hedge losses are not taken into account within five years after the year the losses arise, the deferred hedge losses are also recognized no slower than ratably over the succeeding five years, i.e., one-fifth of the excess in each year.

MTM treatment for hedge losses is consistent with the book treatment, while the deferral of excess hedge losses addresses the timing mismatch of having a GMxB hedge loss and the tax reserve deduction in the same year.

NUMERICAL EXAMPLES

The net hedge gains and losses taken into account for VA contracts issued before Dec. 31, 2009, under Step 4 above can best be illustrated through numerical examples.

Example 1. In Exhibit 1 (page 10), there are positive net hedge gains (see Step 4.a.) accompanied by tax reserve increases. This is a typical example of how a VA contract and associated hedge might behave in a "bear market." The example assumes that the contract was issued prior to Dec. 31, 2009, and that there are no hedge amounts carried forward into Year 1.

The amount of net hedge gain recognized currently in this example (line (3a)) is the amount of net hedge gain to the extent of the net tax deduction (line (1e)). Since the amount of hedge gains exceeds the net tax deduction, the remaining portion of the net hedge gain is carried forward to succeeding years (see line (2b) in Year 2).

If the amount of net hedge gain for the year was less than the

Exhibit 1-Net hedge gain	Year 1	Year 2
1. a. GMxB accrued during year:	10,000	11,000
b. GMxB reserve, beginning of year:	1,000,000	1,200,000
c. GMxB reserve, end of year:	1,200,000	1,300,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	200,000	100,000
e. Net tax deduction relative to VA contract: (1a) + (1d), not less than 0	210,000	111,000
2. a. MTM net hedge gain for year:	250,000	200,000
b. Net hedge gains/(losses) from preceding year:	-	40,000
c. Net hedge gain: (2a) + (2b)	250,000	240,000
3. a. Net hedge gain recognized during taxable year:	210,000	111,000
b. Net hedge gain carried forward to future years:	40,000	129,000

Exhibit 2-Net hedge loss	Year 1	Year 2
1. a. GMxB accrued during year:	n/a	n/a
b. GMxB reserve, beginning of year:	1,200,000	1,000,000
c. GMxB reserve, end of year:	1,000,000	700,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	(200,000)	(300,000)
2. a. MTM net hedge (loss) for year:	(250,000)	(200,000)
b. Net hedge gains/(losses) from preceding year:	-	-
c. Net hedge gain: (2a) + (2b)	(250,000)	(200,000)
3. a. Net hedge loss recognized during taxable year:	(250,000)	(200,000)
b. Net hedge loss carried forward to future years:	-	-

net tax deduction, the entire amount of net hedge gain would be recognized during the year, and no gain would be carried forward to succeeding years.

If there was a decrease in tax reserves during the year, and the decrease was greater than the amount of GMxB accrued during the year, the resulting net tax deduction in line (1e) would be negative and limited to zero. Therefore, any hedge gain would exceed the net tax deduction and be carried forward to succeeding years, i.e., no hedge gain would be recognized during the year.

Example 2. In the case of net hedge losses (see Step 4.b.), the Directive requires such losses up to the increase in GMxB

reserves be carried forward to succeeding years, and the remaining portion of the net hedge loss (if any) is recognized in the current year. Exhibit 2 shows an example of this situation, which is typical of a VA contract in a rising market. Again, the example assumes that the contract was issued prior to Dec. 31, 2009, and that there are no hedge amounts carried forward into Year 1.

In this example, the Directive allows the entire loss on line 2c. to be recognized during the current year, since there is no increase in GMxB tax reserves.

Example 3. If there was an increase in GMxB tax reserves during Year 1, a portion of the loss (up to the increase in reserve) would have to be carried forward, as shown in Exhibit 3.

Exhibit 3-Net hedge loss, Increase in GMxB Reserve	Year 1	Year 2
1. a. GMxB accrued during year:	n/a	n/a
b. GMxB reserve, beginning of year:	1,200,000	1,250,000
c. GMxB reserve, end of year:	1,250,000	700,000
d. Increase/(decrease) in GMxB reserve during year: (1c) - (1b)	50,000	(550,000)
2. a. MTM net hedge (loss) for year:	(250,000)	(200,000)
b. Net hedge gains/(losses) from preceding year:	-	(50,000)
c. Net hedge gain: (2a) + (2b)	(250,000)	(250,000)
3. a. Net hedge loss recognized during taxable year:	(200,000)	(250,000)
b. Net hedge loss carried forward to future years:	(50,000)	-

Eric Bisighini is a Vice President of Tax at The Hartford and may be reached at Eric.Bisighini@thehartford.com.

Tim Branch is a manager, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at Tim.Branch@ey.com.

The net hedge losses, up to the increase in GMxB reserve (line (1d)), are carried forward to Year 2, where they are subsequently recognized along with the Year 2 MTM hedge losses. The remaining portion of net hedge loss in Year 1 is currently deductible.

IMPLEMENTATION RULES

If the company is under examination, or at appeals, it will have the opportunity to make the change in method of accounting in the earliest open year under examination. If the company has a number of open tax years with VA hedging issues, the Directive encourages the company to work with the LB&I examiners to adopt the Directive for a particular tax year. Flexibility to choose the appropriate tax year should have a positive impact on managing audit resources for the IRS and the taxpayer.

If the company is not under examination for any tax year, the company may file a Form 3115 request for an automatic change in accounting, although there is no guarantee the IRS will consent to the change.

In accordance with IRS Revenue Procedure 2002-18, if the new Directive method of accounting results in an adverse adjustment, the increase in taxable income is spread over four years as a §481 adjustment. Favorable adjustments (i.e., decreases in taxable income) are recognized in the year of adoption.

SUMMARY

The IRS's perseverance on this highly complex issue is to be commended. There are many complexities in adopting an accounting method that involves a hedging program with multiple market risks and different types of hedging derivatives. This Directive provides a solution, at least for contracts issued prior to Dec. 31, 2009, which leaves some uncertainty and likelihood for some continued disparity of practice in the industry for companies that have continued to sell and hedge VA business.

The Directive addresses a significant tax issue for life insurance companies that have hedged VA blocks of business. Importantly, the Directive should allow the IRS and the insurance companies to close out open audit years in a timely and cost-effective manner with respect to this issue. ◀

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

END NOTES

- John Quincy Adams, 6th US President (1767-1848), BrainyQuote.com.
- I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012). See Arthur C. Schneider and Samuel A. Mitchell, "IRS Utilizes the Industry Issue Resolution Program to Resolve the Insurance Industry Bad Debt Issue," *TAXING TIMES* Vol. 9, Issue 1 (February 2013) at 20.
- LB&I-04-0514-0050, introduction.
- LB&I-04-0514-0050, "Examination Guidance" and Part A, Step 3.
- Treas. Reg. §1.446-4(e)(1).



John T. Adney is a partner with the Washington, D.C. law firm of Davis & Harman LLP and may be reached at jtadney@davis-harman.com

Nearly 60 years ago, the IRS and the Treasury Department promulgated regulations implementing an innovation for taxing annuity payments under the then new Internal Revenue Code of 1954: the exclusion ratio approach of IRC section 72(b). This approach to tax-free recovery of the investment in the contract, unlike its 1939 Code predecessor, was tailored to the financial characteristics of each annuity contract, and it required the issuance of detailed regulations in order for it to operate successfully. This the regulations issued in 1956 managed to do, drawing on the features of annuity contracts and their payout forms then known. Notably, at the time these regulations were written, the variable payout annuity was new, and there were no deferred annuities with enhanced death benefits or guaranteed minimum withdrawal benefits. There also were no cell phones or personal computers, one could drink a Coca-Cola but not a Diet Coke, the Beatles were still in high school, and the Internet did not exist.

Today's nonqualified annuity contract, whether deferred or immediate, variable or fixed, differs markedly in its features from its 1950s counterpart. And yet, in assessing the federal income tax treatment of distributions from the modern nonqualified annuity, the tax professional must refer to regulations issued during the Eisenhower Administration. While the relevant portion of these regulations was updated in 1986 to reflect mortality improvements and make use of unisex mortality rates, the rules were not changed to record the significant rewrite of the statute by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248 (TEFRA). Accordingly, when an insurer recently sought to determine the tax treatment of new features that it planned to add to its nonqualified deferred variable annuity offerings, the determination needed to be made by deciphering the import of the aging IRC section 72 regulations. As has often been done in recent years, this determination was made by asking the IRS to apply the regulations to the circumstances of the insurer's new product.

In PLR 201424014 (March 10, 2014), released to the public on June 13, 2014, the IRS addressed the income tax treatment of periodic payments to be made under a term certain annu-

IRS APPROVES ANNUITY TREATMENT FOR TERM CERTAIN VARIABLE PAYOUT

By John T. Adney

ity option—styled the “New Annuity Option” in the ruling letter—to be offered under a nonqualified deferred variable annuity contract. Significantly, as explained below, the payments under the New Annuity Option are to be determined and redetermined annually by dividing the account value of the variable annuity by the number of years remaining in the term certain. In other words, after the periodic payments begin, the contract would continue to provide an account value, which could be obtained by the contract owner (or the death beneficiary) by commuting (i.e., surrendering) the contract in whole or part. The IRS agreed with the insurer's requests that the taxable portion of each of the periodic payments would be computed by applying an exclusion ratio under the IRC section 72(b) regulations, and that the existence of the commutation rights would not give rise to constructive receipt of the account value.

THE FACTS

According to the IRS's ruling letter, the New Annuity Option is to be made available to owners of the insurer's nonqualified deferred variable annuity contracts to obtain a term certain annuity with variable payments. If a contract owner elects the New Annuity Option, the owner must select the number of years in the term certain annuity period, which must be at least an insurer-specified minimum number of years but must not extend beyond a stated age of the owner (or in the case of joint or contingent owners, that of the younger owner). The owner's election may be revoked, but only before the first periodic payment is made. Unless the election is revoked, there can be no change in the contract's ownership, the identity of the annuitant, or (absent a commutation) the duration of the annuity term.

The annual amount of the periodic payments to be made in the first year under the New Annuity Option is to be determined when the insurer receives the contract owner's election, and the amount payable in each of the subsequent years is to be determined on the day before each anniversary of that election. For each year, the annual amount is calculated by dividing the contract's account value at that time by the number of years remaining in the annuity term. Because the underlying con-

tract is a variable one, with values reflecting gains and losses in the variable subaccount investments, this account value is expected to fluctuate, and so the annual amount also is expected to fluctuate in relation to it. The IRS ruling letter notes, however, that the account value always would decrease as the annuity term progresses, and would reach zero at the term's end. By way of (a highly oversimplified) example, assume that in year x, when a 20-year payout begins, the account value is \$10,000. The annual payment amount for that year would be $\$10,000/20 = \500 . Then, for year x+1, the account value has been increased by \$400 in earnings. The annual payment amount for x+1 would be $(\$10,000 - \$500 + \$400)/19 = \521 (with rounding).

Under the New Annuity Option, the contract owner may take the annual amount of the periodic payments in monthly or quarterly installments as well as in an annual sum. The owner also may commute (the ruling letter uses the term "redeem") the contract's account value, in whole or part, after the periodic payments begin. A complete commutation terminates the payments and the contract, while a partial commutation results in a *pro rata* reduction of the future periodic payments. On the death of an owner (or annuitant in the case of a contract held by a non-natural person) during the annuity term, the periodic payments are required to continue for the remainder of the term as required by IRC section 72(s)(1)(A), subject to a death beneficiary's right to commute the account value in whole or part.

THE IRS'S RULINGS

Apart from summarizing the relevant rules of the tax law, the IRS ruling letter did not provide much by way of a rationale for the agency's holding on the treatment of the periodic payments under the New Annuity Option. The letter sets out the applicable portions of IRC section 72 and the regulations thereunder, explaining that under Treas. Reg. section 1.72-2(b)(2)-(3), payments from an annuity contract are considered "amounts received as an annuity" if (1) they are received on or after the "annuity starting date" as defined in Treas. Reg. section 1.72-4(b)(1), (2) they are payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and (3) in the case of periodic payments that may vary in accordance with investment experience, they are to be received for a "definite or determinable time (whether for a period certain or for a life or lives)." The letter also states that, as provided in Treas. Reg. section 1.72-2(b)(3), to the extent each variable payment does not exceed the investment in the contract divided by the number



of anticipated periodic payments, it is considered an amount received as an annuity and is excludable from income—that is, the exclusion ratio is 100 percent—and any excess is treated as an amount not received as an annuity. An amount not received as an annuity after the annuity starting date is fully includable in income pursuant to IRC section 72(e)(1)(A). This description is none other than the traditional exclusion ratio approach applied to a variable payout annuity.

Applying these rules to the facts of the New Annuity Option, the IRS concluded, as requested by the insurer, that the traditional exclusion ratio approach would apply as it normally would for variable annuity payments. Thus, the ruling letter held that each periodic payment under the New Annuity Option would be an "amount received as an annuity," and thus excludable from gross income, to the extent that it does not exceed the amount computed by dividing the investment in the contract by the number of payments anticipated during the annuity term. The remainder of each payment would be treated as an amount not received as an annuity, and thus fully includable in gross income. Using the 20-year term in the example given above, and assuming that the investment in the contract at the annuity starting date was \$8,000, this would produce an annual exclusion of \$400 ($\$8,000/20$). Hence, of the \$500 payment in the example for year x, \$100 would be includable in income, and of the \$521 payment in year x+1, \$121 would be includable.

The insurer also asked the IRS to rule that following the election of the New Annuity Option, no amount would be includable in the owner's income before its actual payment under the option, *i.e.*, that there would be no constructive receipt of the contract's account value. The IRS so ruled, basing its holding

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on a number of observations. These included, first, that IRC section 72 provides a “comprehensive scheme” for the taxation of annuity contracts, namely, IRC sections 72(a) and (e) expressly require that amounts be “received” before they are included in gross income; in so saying, the IRS repeated what it had observed many times before. Second, prior to TEFRA the doctrine of constructive receipt did not apply to annuities, and the TEFRA changes to IRC section 72 did not alter this. Third, IRC section 72(e)(4)(A), which provides that a loan or a pledge of a nonqualified annuity is treated as a distribution, is inconsistent with application of the doctrine of constructive receipt in other circumstances. The ruling letter also mentions IRC section 72(u) (imposing current taxation on the cash value buildup of an annuity owned by a non-natural person) as a basis for its conclusion.

REFLECTIONS ON PLR 201424014

This private letter ruling is significant for two reasons. First, it is only the second ruling addressing whether periodic payments calculated in this manner, i.e., using an “RMD” type of method, are eligible for IRC section 72(b) “exclusion ratio” treatment. The earlier ruling addressing this manner of calculating annuity payments, PLR 200313016 (Dec. 20, 2002), also dealt with the implications of a full surrender after the periodic payments commenced, but it did not address the implications of a partial surrender. The new ruling indicates that allowing partial surrenders under this type of design does not preclude exclusion ratio treatment.

Second, the new ruling does not address the treatment of amounts received on a partial or complete commutation under the New Annuity Option. However, the ruling letter contains a statement that the insurer would treat amounts received in a partial commutation as fully includible in income. Hence, the insurer would not treat a portion of a partial commutation as a tax-free recovery of the investment in the contract under Treas. Reg. section 1.72-11(f)(2). According to IRS Publication 575, *Pension and Annuity Income*, this regulation applies to partial commutations, but the IRS has indicated in prior private letter rulings that it believes the regulation does not apply (see PLR 9237030 (June 16, 1992) and PLR 200030013 (April 27, 2000)).

Given the interest of insurers in developing new nonqualified payout annuity products while simultaneously providing access to a surrender value, it would not be at all surprising to see more rulings of this type. The accurate application of the aging regulations under IRC section 72, which govern the tax treatment of such products, is essential for both insurers and contract owners. The insurer in PLR 201424014 took the right step in seeking guidance from the IRS. ◀

THE ALLOCATION OF FATCA WITHHOLDING RISK IN CROSS-BORDER REINSURANCE AGREEMENTS

By Jason Kaplan and Christine Lane



IN BRIEF

Enacted in 2010 (but with phased implementation), the Foreign Account Tax Compliance Act (FATCA) is an information reporting regime that is enforced through a 30 percent gross basis withholding tax on “withholdable payments” made to foreign non-compliant entities. FATCA is part of an overall U.S. enforcement effort intended to help “close the tax gap” by identifying U.S. citizens and U.S. residents who beneficially own financial accounts at foreign financial institutions (FFIs) or interests in non-financial foreign entities (NFFE) but do not disclose such holdings (or report the associated income) on their U.S. tax returns.

FATCA’s implementation raises potentially significant issues in cross-border reinsurance transactions. Unless an exemption is established, FATCA withholding applies to U.S. source premiums paid to a foreign reinsurer regardless of whether the underlying policies have a cash value or investment component of the type subject to FATCA information reporting.¹ Although these premiums may be subject to a 1 percent U.S. federal excise tax under Internal Revenue Code section 4371 (the FET),² they typically are exempt from 30 percent U.S. withholding tax otherwise imposed under Internal Revenue Code section 1442 on payments to a foreign corporation.³ Over industry objections, final Treasury regulations relating to the implementation of FATCA do not similarly exempt premium income from FATCA withholding because of FET.

This article summarizes key contractual provisions that should be considered in cross-border reinsurance agreements in light of FATCA’s implementation, including the commencement of FATCA withholding on July 1, 2014.⁴

OVERVIEW OF FATCA AS APPLIED TO FOREIGN REINSURERS

The aspect of FATCA that is most problematic in a typical cross-border reinsurance transaction is the requirement that U.S. payors of withholdable payments withhold 30 percent of such amounts unless the payee establishes an exemption.

Withholdable payments include interest, dividends, rents, royalties, salaries, wages, annuities, premiums and other fixed or determinable annual or periodical (FDAP) income, gains, and profits, provided such payments are considered U.S. source income. Reinsurance premiums relating to underlying U.S. risks are treated as U.S. source FDAP income and considered withholdable payments. The final FATCA Treasury regulations exclude certain “financial services” payments from the definition of withholdable payments, but premiums are not treated as financial services payments.

“SPECIFIED INSURANCE COMPANY”

An FFI is defined broadly by final Treasury regulations and includes traditional deposit taking entities such as banks, custodial entities that hold financial assets on behalf of others, and investment funds that are primarily in the business of investing, reinvesting, or trading in securities or other financial assets. Insurance companies generally are not considered investment entities because the bona fide reserves of an insurance company are not treated as financial assets for FATCA classification purposes. But an insurance company issuing or obligated to make payments with respect to cash value insurance or annuity contracts is classified as an FFI (a “Specified Insurance Company”).⁵ A cash value insurance contract for FATCA purposes is an insurance contract (other than an indemnity reinsurance contract between two insurance companies and a term life insurance contract) that has an aggregate cash value greater than U.S. \$50,000 at any time during the calendar year.⁶

Specified Insurance Companies may avoid being subject to FATCA withholding on U.S. source premiums by complying with FATCA’s account due diligence, documentation and information reporting requirements; registering with the IRS to obtain a Global Intermediary Identification Number (GIIN); and providing certifications on U.S. tax forms or other documentary evidence of FATCA compliant status. These requirements may be altered for FFIs resident in jurisdictions that have entered into an Intergovernmental Agreement (IGA) with the United States.⁷

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Jason Kaplan is a partner in the New York offices of Hogan Lovells US LLP and may be reached at jason.kaplan@hoganlovells.com.

Christine Lane is a senior associate in the Washington, DC offices of Hogan Lovells US LLP and may be reached at christine.lane@hoganlovells.com.

FOREIGN REINSURERS NOT CLASSIFIED AS SPECIFIED INSURANCE COMPANIES

Foreign reinsurers not classified as Specified Insurance Companies are treated as non-financial foreign entities (NFFEs). There are two basic categories of NFFEs—“exempt” and “passive.” Exempt NFFEs include “active” NFFEs that are primarily engaged in business activity other than holding assets that produce passive income and NFFEs having publicly traded shares. NFFEs are not required to register with the IRS or comply with FATCA’s account due diligence and information reporting requirements, but exempt NFFEs may be required to certify their FATCA exempt status on appropriate U.S. tax forms.

Foreign reinsurers that are not Specified Insurance Companies generally are classified as passive NFFEs because the investment assets supporting their reserves are treated as passive assets that produce passive income. (This rule differs from the approach taken under the passive foreign investment company (PFIC) rules in that the PFIC rules do not treat as passive income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and that would be subject to tax under Subchapter L of the Internal Revenue Code if it were a domestic corporation.) To avoid FATCA withholding on payments of U.S. source premiums, passive NFFEs are required to disclose on appropriate U.S. tax forms “substantial U.S. owners” or certify that no “substantial U.S. owners” exist.⁸

FATCA’S IMPACT ON THE DOCUMENTATION OF CROSS-BORDER REINSURANCE TRANSACTIONS:

U.S. MARKET APPROACH

In the authors’ experience, the evolving market position on allocation of FATCA withholding risk in reinsurance transactions is to shift the risk to the foreign reinsurer. This generally is consistent with the approach taken in financial transactions including loan, swap and derivatives transactions. For example, the Loan Syndication and Trading Association (LSTA) model credit agreement provisions exclude U.S. federal withholding taxes imposed on payments by reason of FATCA from the tax gross-up. Accordingly, the foreign lender bears the risk of any FATCA withholding on payments of interest and principal as a borrower will not be required to “gross-up” or pay additional amounts if the borrower is required to withhold under FATCA. The International Swaps and Derivatives

Association (ISDA) has followed a similar approach to the LSTA, and recommends a FATCA carve-out on payments subject to the tax gross-up.⁹

FOREIGN MARKET APPROACH

The foreign market’s response in allocating FATCA withholding risk in financial transactions arguably is not as settled as the U.S. market. For example, the Loan Market Association (LMA), a leading foreign trade association focused on improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa, has issued three riders to standard loan documentation taking various approaches to FATCA. The LMA riders allocate FATCA withholding risk entirely to the: (i) borrower, or (ii) lender either in a limited manner (allocation of the FATCA risk assuming the obligation is “grandfathered” with a right of termination if grandfathering status is lost, e.g., by reason of a “material modification”) or unlimited manner (whereby the lender bears the risk of FATCA withholding, although in such cases the borrower may represent that no payments are U.S. source). The LMA issued a further statement adopting the “lender unlimited” approach in its default LMA model agreements (accordingly, payments pursuant to default LMA loan agreements can be made net of any deduction for FATCA withholding).¹⁰

ALLOCATION OF FATCA WITHHOLDING RISK TO FOREIGN REINSURER

Assuming that the foreign reinsurer agrees to bear the risk of FATCA withholding, the following contractual provisions should be considered in the reinsurance agreement:

- **Provision for U.S. Tax Forms.** The reinsurance agreement should require the foreign reinsurer to provide IRS Form W-8BEN-E, or other required U.S. tax forms or certifications, prior to any payment of premiums to certify its FATCA exempt status. An ongoing contractual requirement for the reinsurer to update such information is desirable (although the applicable U.S. federal tax rules require the updating of such forms if there is a change in status or if the form expires).
- **Requiring FATCA Compliance.** How and to what extent does the U.S. cedent have the right to force the FFI or NFFE reinsurer to comply with FATCA throughout the duration of the reinsurance agreement? In this respect, it may be useful to include both a representation in the

reinsurance agreement whereby the reinsurer represents that it is presently FATCA compliant and a covenant that the reinsurer will continue to be FATCA compliant during the term of the reinsurance agreement. This should protect the cedent in the event it suffers losses as a result of the reinsurer's non-compliance with FATCA.

- **Right to Withhold.** The U.S. cedent should have the right to withhold FATCA tax should any payments of premium become subject to FATCA withholding by reason of the foreign reinsurer's failure to provide the U.S. cedent with the necessary documentation establishing an exemption from withholding.
- **No Right of Set-Off.** The U.S. cedent's withholding of any amounts under the reinsurance agreement should not be subject to a right of set-off. To allow set-off would essentially shift the burden of FATCA withholding to the U.S. cedent in many instances.
- **No Cancellation or Defense.** Any amounts required to be withheld pursuant to FATCA should not provide the foreign reinsurer with any right to cancel or terminate the reinsurance agreement and withholding should not be a defense to payment of losses or treated as a breach of the agreement.

THE ALLOCATION OF FATCA WITHHOLDING RISK WHERE A BROKER IS INVOLVED—THE FATCA SELF-EXECUTING SOLUTION

Prior to the release of the final FATCA regulations, the rule for withholding in arrangements that involved brokers required the U.S. cedent to look through the broker to the ultimate payee (the foreign reinsurer) to determine the foreign reinsurer's FATCA status (and obtain appropriate U.S. tax forms claiming an exemption from FATCA withholding). Under the final Treasury regulations, U.S. brokers are considered payees (unless the insured has reason to know that the broker is not complying with its FATCA withholding obligations). As a result of the final rule, U.S. brokers have FATCA withholding responsibility as the last U.S. party in the chain of payment. In the authors' experience, the current trend in the reinsurance marketplace is for U.S. brokers to place reinsurance only with FATCA compliant reinsurers.



Given the revisions in the final Treasury regulations, reinsurance arrangements involving a U.S. broker should include an intermediary clause whereby payments made to the broker are deemed to be payments made to the reinsurer. Such a provision protects the U.S. cedent from the possibility that FATCA withholdings deducted by the broker from premium payments would give rise to a termination or cancellation of the contract by reason of failure to pay the full amount of premiums due.

If the broker is foreign, the U.S. cedent may be required to obtain the FATCA exemption documentation from the reinsurer and may bear FATCA withholding risk as the last U.S. party in the chain of payment.

Brokers are not treated as intermediaries with respect to "offshore obligations" (generally, a contract maintained and executed at an office of the withholding agent outside of the United States or in a U.S. territory). Consequently, FATCA's transition rule for offshore obligations (which defers withholding through the end of 2016 for payments made in respect of offshore obligations, unless made through an intermediary) should apply. The IRS has indicated informally that any doubt as to whether insurance qualifies as an offshore obligation for this purpose will be clarified. ◀

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END NOTES

- ¹ Contracts issued after June 30, 2014 are not covered by the “grandfathering” rules.
- ² FATCA is separate from the federal excise tax under Code section 4371. If the excise tax applies under Code section 4371, FATCA may still apply and require 30 percent withholding in addition to any applicable excise tax.
- ³ Treas. Reg. § 1.1441-2(a)(7) (insurance premiums paid with respect to a contract that is subject to the section 4371 excise tax are not subject to U.S. federal withholding taxes).
- ⁴ The relevant FATCA citations to the Code and U.S. Treasury Regulations are omitted. The relevant FATCA Code sections (and corresponding Treasury regulations), unless otherwise noted, are at sections 1471 through 1474 of the Code.
- ⁵ An “insurance company” for FATCA purposes includes any entity or arrangement that is (i) regulated as an insurance business under the laws, regulations, or practices of any jurisdiction in which the company does business, (ii) the gross income of which arising from insurance, reinsurance, and annuity contracts for the immediately preceding calendar year exceeds 50 percent of total gross income for such year, or (iii) the aggregate value of the assets of such entity or arrangement associated with insurance, reinsurance, and annuity contracts at any time during the immediately preceding calendar year exceeds 50 percent of total assets at any time during such year. This definition differs from the rule applicable to U.S. life insurance companies under Code section 816(a) which provides that the term “life insurance company” means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or non-cancellable contracts of health and accident insurance, if (i) its life insurance reserves, plus (ii) unearned premiums, and unpaid losses (whether or not ascertained), on non-cancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. For purposes of Code section 816(a), the term “insurance company” means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.
- ⁶ Final FATCA regulations issued Feb. 20, 2014 provide that foreign insurance companies electing under Code section 953(d) to be treated as U.S. persons for U.S. tax purposes may be treated as U.S. persons for FATCA purposes if the foreign insurance company is not a Specified Insurance Company or is a Specified Insurance Company licensed to do business in any state in the United States. The consequence of being treated as a U.S. person is that the 953(d) company may avoid being withheld upon under FATCA.
- ⁷ There are four alternative possibilities with respect to the FATCA status of a foreign reinsurer that is an FFI, the: (i) foreign reinsurer is located in a Model 1 IGA country (e.g., Cayman Islands); (ii) foreign reinsurer is located in a Model 2 IGA country (e.g., Bermuda); (iii) foreign reinsurer is located in a country with no IGA, but registers and enters into an FFI Agreement with the IRS; or (iv) foreign reinsurer is located in a country with no IGA and it neither registers nor enters into an FFI Agreement with the IRS.
- ⁸ “Substantial U.S. ownership” includes any specified U.S. person owning, directly or indirectly, more than 10 percent of the (i) stock of a foreign corporation (by vote or value), (ii) profits or capital interests of a foreign partnership, or (iii) beneficial interests of a foreign trust. To address industry concerns about disclosure of U.S. owners to brokers and ceding companies, the IRS will allow a passive NFFE to directly report certain information to the IRS in lieu of providing ownership information to third party payors, provided that requirements specified in the applicable Treasury regulations are satisfied.
- ⁹ ISDA is a trade association that publishes a standard agreement for privately negotiated derivatives transactions.
- ¹⁰ 2014 Summary Note on FATCA (released June 9, 2014).

REV. RUL. 2014-15: THE REQUIREMENT OF RISK DISTRIBUTION, THE LAW OF UNINTENDED CONSEQUENCES, AND NEW QUESTIONS TO CONSIDER IN FUNDING RETIREE HEALTH BENEFITS

By Terrance F. Richardson and Mark S. Smith

In Rev. Rul. 2014-15,¹ the Internal Revenue Service and Treasury provided both certainty on the use of a captive insurance company to fund retiree health benefits, and a lesson in the law of unintended consequences. Many questions remain, however, for taxpayers who enter into structures similar to that in the ruling.

THE RULING AND ITS ANALYSIS

The facts of the ruling are straightforward and not uncommon. X, a publicly-traded domestic corporation, maintains a single-employer voluntary employees' beneficiary association (a VEBA). X made a contribution to the VEBA to fund health benefits for a large group of named retired employees and their dependents. X deducted the contribution to the extent permitted under sections 419 and 419A of the Internal Revenue Code. As an alternative to self-insuring the benefits, the VEBA entered into a noncancellable accident and health insurance contract with IC, an unrelated commercial insurance company.² Neither X nor the VEBA has any legal obligation to provide health benefits to the covered retirees and their dependents; in fact, both may cancel any provided coverage at any time.

In order to control costs, IC entered into a contract (Contract B) with S1, a wholly-owned subsidiary of X, under which it reinsured 100 percent of its obligations under the contract with the VEBA. The reinsurance contract with IC constitutes S1's only business and requires payment of arms'-length premiums. S1 is regulated as an insurance company, and possesses adequate capital to fulfill its obligations under the contract. There are no guarantees that VEBA or X will reimburse S1 with respect to its obligations, nor is any amount of the premium loaned back to the VEBA or to X. In all respects, the parties conduct themselves in an arms'-length manner, except that S1 does not reinsure any other contracts.

The ruling first summarizes the requirements that must be met in order for a contract to be treated as an insurance contract, and for a business entity to be taxed as an insurance company. In particular, the ruling explains that risks that are the subject of the arrangement must be insurance risks and not merely



investment or business risks, and that those risks must be shifted from the policyholder to the issuer and distributed, or pooled, such that the law of large numbers may operate.³ Those requirements were met under the facts in the ruling. This is because the covered retirees' health coverage represented insurance risks, and because Contract B shifted those risks from the retirees to S1. On this point, the analysis of the ruling was made easy because the risks were solely those of the retirees: Neither X nor the VEBA had any obligation to provide the benefits. Under the analysis of the ruling, the requirement of risk distribution was met because the risks under Contract B are distributed among a large number of covered individuals. Because Contract B represents more than half (in fact, all) of S1's business, S1 qualifies as an insurance company under the more-than-half the business test of sections 831(c) and 816(a).

A TENSION THAT WAS NOT THERE

The publication of Rev. Rul. 2014-15 was in response to a request from a law firm that had previously requested a Private Letter Ruling (PLR) to the same effect on behalf of a large corporation.⁴ The law firm's request for guidance described a "possible misunderstanding" of existing published rulings that prevented the timely issuance of its requested PLR. The law firm's letter requested a revenue ruling that would distinguish the insurance of employee health from a single company's insurance of its own risks, such as those related to its ownership and leasing of multiple motor vehicles. In short, the letter served up the issue as an arguable inconsistency between two previously-published rulings: Rev. Rul. 92-93⁵ and Rev. Rul. 2005-40.⁶

In Rev. Rul. 92-93, a domestic manufacturing corporation provided life insurance to its active employees under a group-term life insurance contract purchased from its wholly-owned insurance subsidiary. The terms of the contract were customary in the industry, and there was no guarantee of renewal, nor were permanent benefits (such as a cash surrender value) provided. The ruling concludes that although the employer corporation purchased the group-term life insurance from its subsidiary, this fact did not cause the arrangement to be

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“self-insurance” because the economic risk of loss being insured is not a risk of the employer, rather it is a risk—the mortality risk—of the employees. The ruling recites that “[t]he holdings of this revenue ruling also apply to accident and health insurance.” The Service applied a similar analysis in Rev. Rul. 92-94 to a nonlife insurance company insuring its own employees, concluding that the company’s gross premiums written include amounts the company charged itself with respect to liability for insurance and annuity benefits for the employees. Again, according to the Service, the arrangements were not non-deductible self-insurance because the company’s assumption of liabilities shifts the employees’ risks to the insurance company.⁸

In Rev. Rul. 2005-40, the Service concluded that an arrangement entered into with a single policyholder cannot qualify as an insurance contract for Federal income tax purposes if the issuer does not enter into contracts with other policyholders.

According to the ruling, such an arrangement cannot satisfy the risk distribution requirement regardless of the number of statistically independent risk units that are insured. This position has generated considerable debate. On the one hand, an economist or actuary may reasonably conclude that the requirement of risk distribution is met (and the law of large numbers may operate) with regard to a contract with a single policyholder if that single contract represents a sufficient number of independent underlying risks, such as a fleet of vehicles—or a pool of employees or retirees. On the other hand, the Service is rightfully concerned that a deduction

generally is not permitted for the prefunding of future losses that do not otherwise meet the requirements of the all-events test and economic performance. The line between insurance and non-insurance is of broad consequence.

The Service may not have foreseen some of the corollary issues that resulted from the publication of Rev. Rul. 2005-40. For example, shortly after Rev. Rul. 2005-40 was published, practitioners requested clarification that the position in Rev. Rul. 2005-40 would not be applied to a single reinsurance con-

tract issued by a reinsurer where the reinsurance contract itself represents an entire block of insurance business, with a sufficiently large number of unrelated policyholders and risks.⁹ In response, the Service issued Rev. Rul. 2009-26,¹⁰ confirming exactly that. Nor did many practitioners foresee the relatively little weight that the Tax Court would accord the concentration of risks in a relatively small number of policyholders in *Rent-A-Center v. Commissioner*. In that case, the Tax Court concluded that an arrangement qualified as insurance and did not even discuss the number of policyholders, even though according to the Service’s brief the related risks that were covered were concentrated in just three policyholders, and two-thirds of the risks related to a single policyholder.¹²

One might view the publication of Rev. Rul. 2014-15 as yet another unintended consequence of Rev. Rul. 2005-40. That is, having concluded categorically that an arrangement pooling a large number of unrelated risks of just one policyholder cannot be insurance, the Service’s analysis of insurance qualification must necessarily delve deeper into questions involving whose risk is whose.

Ironically, Rev. Rul. 92-93 and Rev. Rul. 2005-40 need not have been viewed as offering competing analyses of risk distribution. If the Service had interpreted (as do most practitioners) Rev. Rul. 92-93 as looking through to the insured employees as the ultimate policyholders, there was no inconsistency with Rev. Rul. 2005-40 to resolve. Under the analysis of Rev. Rul. 92-93, the insurance contract between the VEBA and IC represented a large group of named retirees and their dependents. The “single insured” position in Rev. Rul. 2005-40 thus was not implicated. Rev. Rul. 2014-15 acknowledges as much by “distinguishing” Rev. Rul. 2005-40.¹³

IMPORTANT QUESTIONS UNANSWERED

At least as important as the questions answered in Rev. Rul. 2014-15 are the questions that remain unaddressed. It is, of course, important that the ruling concluded what is obvious: under the facts presented, S1 qualified as an insurance company for Federal income tax purposes. A company planning a transaction such as that described in the ruling, however, likely needs answers to additional questions, including questions on which the ruling explicitly provides no guidance.

For example:

The contract that S1 issued provides noncancellable accident and health coverage. Under section 816(b) of the Code,

A company planning a transaction such as that described in the ruling ... likely needs answers to additional questions, including questions on which the ruling explicitly provides no guidance.

reserves with regard to noncancellable accident and health insurance contracts may be life insurance reserves. Because the contract that S1 issued is its only business, S1 would qualify as a life insurance company, although the ruling does not say so. Does life company qualification mean that the life-nonlife consolidated return limitations apply, and prevent the utilization of S1 losses, if any, for the first five years it is in the group? Are there approaches to avoid this result?

Also, under the facts of the ruling, X is not legally obligated to provide health benefits to its retirees and may cancel coverage at any time. Would the conclusion be different if, instead of retirees, the contract insured the health of active employees and X were obligated to provide coverage such as under a collective bargaining agreement? Would the ruling treat the Affordable Care Act employer mandate as an obligation to provide coverage? Although the risks at issue would still be those of the individuals, arguably the risks could also be viewed as risks of X because the ACA requires the employer to provide coverage or pay a fine for not doing so. The likeliest analogy in that case would likely still be Rev. Rul. 92-93, or perhaps Rev. Rul. 2006-95 (concerning reinsurance), but Rev. Rul. 2014-15 does not address these facts directly.

The ruling addresses only circumstances in which welfare benefits are provided through a VEBA. It does not address other circumstances, such as the provision of welfare benefits other than through a VEBA, or the provision of benefits that might be deferred compensation. In theory, one would expect the same conclusion that S1 is an insurance company if instead the employer contracted with S1 directly (or through a fronting insurer if it were an ERISA benefit¹⁴) and no VEBA was involved. Different rules, however, govern the timing of deductions for insurance premiums than govern the timing of deductions for deferred compensation.

Another explicit caveat concerns the status of the contract with S1 as a self-insured medical reimbursement plan for purposes of the nondiscrimination rules of section 105(h). The ruling does not give any reason for this caveat, but the fact that it is there suggests that companies should consider the applicability of section 105(h) on their own facts.

And, perhaps most importantly, would the same analysis apply to a medical stop-loss policy as applies to the contract with S1? Presumably, if an employer, either directly or through a VEBA, enters into a medical stop-loss policy with



Terry Richardson is a partner in the Human Resource Services practice of Pricewaterhouse Coopers LLP (PwC), focusing on employee benefits and captive insurance.

Mark Smith Esq., CPA, is a managing director, Washington National Tax Services with Pricewaterhouse-Coopers LLP, and may be reached at mark.s.smith@us.pwc.com.

a captive insurer, one would still look through to the underlying insured employees to determine whether the insurance requirement of risk distribution is met. Medical stop-loss arrangements are common. The ruling's failure to shed light on their treatment does not prevent the issue from coming up in this context and others. Rather, it leaves taxpayers and their advisors to make their best judgment as to how existing judicial authorities should be applied.

The insurance company conclusion in Rev. Rul. 2014-15 provides welcome certainty on the facts of the ruling and is clearly correct, even obvious. The Service and Treasury are no doubt aware there is unfinished business in this area, however. As discussed, the ruling declines to address a number of issues concerning the taxation of employee benefits, and even the ruling's insurance conclusion is limited to the ruling's facts. There may be further guidance. Meanwhile, employers and their advisors are working through corollary issues on a case-by-case basis. ◀

ENDNOTES

- ¹ 2014-24 I.R.B. 1095 (June 9, 2014).
- ² The participation of an unrelated insurance company is a condition of an exemption from the Department of Labor from the prohibited transaction provisions of the Employment Retirement Income Security Act of 1974 (ERISA).
- ³ The ruling did not discuss the third prong of *AMERCO v. Commissioner*, 96 T.C. 18 (1991), *aff'd* 979 F.2d 162 (9th Cir., 1992), to the effect that an arrangement must constitute insurance in the commonly accepted sense. Presumably this requirement merited no discussion as it is clearly met in the case of health benefits of individuals.
- ⁴ May 11, 2011, letter of Theodore R. Groom in response to Notice 2011-39, 2011-20 I.R.B. 786 (April 16, 2011), Tax Analysts Doc. 2011-11073.
- ⁵ 1992-2 C.B. 45, *modified by* Rev. Rul. 2001-31, 2001-1 C.B. 1348.
- ⁶ 2005-2 C.B. 4.
- ⁷ 1992-2 C.B. 144.
- ⁸ See also Rev. Rul. 80-95, 1980-1 C.B. 252, which analyzed a disability policy between a domestic employer and a foreign insurer as a "policy of life, sickness or accident insurance" for purposes of the excise tax imposed by section 4371, even though the insured employees were not directly parties to the contract.
- ⁹ See, e.g., August 26 2005, letter of George W. Craven in response to Notice 2005-49, 2005-2 C.B. 14, Tax Analysts Doc. 2005-19415.
- ¹⁰ 2009-38 I.R.B. (Sept. 21, 2009).
- ¹¹ 142 T.C. 1 (2014).
- ¹² Opening Brief for Respondent at 50, *Rent-A-Center v. Commissioner*, 142 T.C. 1 (2014) (Nos. 8320-09, 6909-10, 21627-10).
- ¹³ The ruling also distinguishes Rev. Rul. 2002-89, 2002-2 C.B. 984, which concludes that the requirements of risk shifting and risk distribution are not satisfied when a wholly-owned subsidiary's agreement to indemnify the risks of its parent represents 90% of the subsidiary's business.
- ¹⁴ If the benefit at issue were covered by the Employee Retirement Income Security Act of 1974 (ERISA), the parent company would be required to obtain a prohibited transaction exemption. Provided the parent is not in the business of insurance, a key requirement of such an exemption would be the use of a fronting insurer to contract with the employee benefit plan and reinsure the coverage with the captive.

U.S. TAX ASPECTS OF ASSET/LIABILITY MATCHING FOR INSURANCE

By Aditi Banerjee, Brion D. Graber and Peter H. Winslow

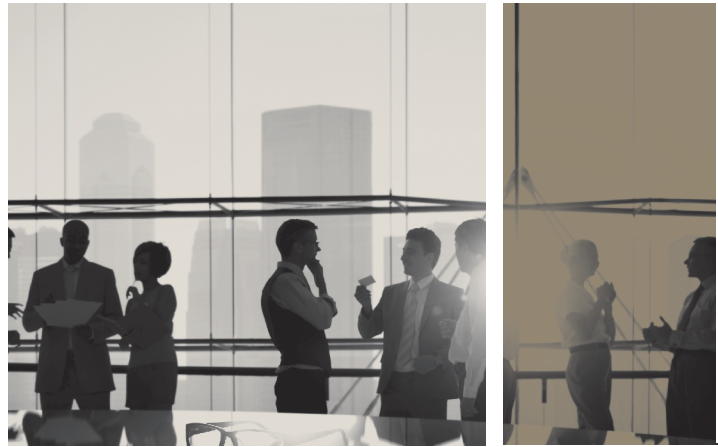
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At the March 2014 Investment Symposium, Dave Bell, Aditi Banerjee and Peter H. Winslow participated in a panel presentation (Session E2) titled “Tax Aspects of Asset/Liability Matching.” The presentation discussed key tax issues that exist under current law with respect to asset rebalancing and hedging transactions that an insurance company might undertake. As a follow-up to that presentation, and in an effort to convey the information to a broader audience, this article summarizes the substance of that discussion for the readers of *Risks & Rewards*. Readers who would like to learn more about other tax issues of interest to individuals in the insurance industry can find informative articles in *TAXING TIMES*, the Taxation Section’s newsletter.

SOURCES OF TAX CHARACTER AND TIMING MISMATCHES ON ASSET/LIABILITY BALANCING TRANSACTIONS

The fundamental tax quandary faced in insurance company asset/liability balancing transactions is a capital/ordinary mismatch in tax treatment. An insurance company’s liabilities are reflected in tax reserves, which are ordinary in character for tax purposes (i.e., increases and decreases in tax reserves generate ordinary deductions and income, respectively). On the other hand, the assets used to satisfy these liabilities are capital in character for tax purposes. Moreover, income earned on capital assets is generally ordinary in nature while gain and loss on the underlying assets is capital in nature. This causes tax inefficiency, because capital losses on assets cannot generally be used to offset previous ordinary income earned on the assets.

This tax inefficiency is exacerbated in a credit loss environment. Credit losses are generally recognized for tax purposes only upon sale or maturity and are generally treated as capital losses. However, the income earned on the bond prior to sale or maturity would be ordinary in character. Moreover, a purchase of a distressed debt instrument at a discount often generates “market discount” income, which treats the discount in purchase price as ordinary interest income for tax purposes. In effect, a taxpayer is required to recognize ordinary interest income for tax purposes that it may never collect if the debt is of poor credit quality.



LIMITATIONS ON USE OF CAPITAL LOSSES

Capital losses can only offset capital gains.¹ Any unused capital losses can only be carried back three years and carried forward for five years.² In a rising interest rate environment, a large amount of capital losses may be generated without offsetting capital gains within the relevant carryback/carryforward period. For statutory accounting purposes, loss carryforwards are reflected as deferred tax assets (DTAs) on the balance sheet. However, there are limitations on the ability to admit DTAs as capital. DTA admittance is limited by the amount of taxes paid by the company in the current year and the prior two years. Thus, at a time when substantial capital losses are generated, the company may be able to admit only a minimal amount of DTAs if it has been in a loss position in the past few years.

MANAGING TAX CAPACITY FOR CAPITAL LOSSES

This asymmetry between capital loss and ordinary income may be managed through two principal means, subject to accounting, business and regulatory constraints: (1) triggering embedded capital gains through sale/repurchase transactions or through special tax structuring transactions; and (2) obtaining an ordinary deduction through a partial worthlessness deduction.³

OPTIONS FOR TRIGGERING CAPITAL GAINS ON APPRECIATED BONDS

In order to utilize capital losses before they expire, a taxpayer may trigger embedded capital gains through a variety of mechanisms. This can be achieved through a sale and repurchase of a bond, through a sale and a purchase of another bond, or through certain tax technology, including the use of identified mixed straddle transactions or through constructive sales, discussed in more detail below.

Sale and repurchase transactions are constrained by regulatory considerations. Regulatory requirements for asset and liability matching narrow the universe of investments that may be included in a portfolio. In addition, if appropriate substitute bonds are not found, cash flow testing reserves may be increased by regulators. The accounting treatment may also

CONTINUED ON **PAGE 24**

be unfavorable. Generally, if a bond is sold at a gain because yields have declined, repurchase of a lower-yield bond would trade future yield for a one-time gain. For Generally Accepted Accounting Principle (GAAP) purposes, the one-time gain reduces future investment income through the duration of the investment.

As an alternative to actual sales to recognize capital gains, life insurance companies have entered into identified mixed straddles that result in deemed asset sales for tax purposes. An identified mixed straddle is the holding of offsetting positions with respect to actively traded property that includes an I.R.C. § 1256 contract (which is any regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or securities future contract) and a non- I.R.C. § 1256 contract (i.e., anything other than an I.R.C. § 1256 contract) that is specifically identified.⁴ Historically, the unrealized gain or loss on a position in an identified mixed straddle is required to be recognized on the day prior to establishing the identified mixed straddle. As a result, by selecting bonds with unrealized gain to be part of an identified mixed straddle, capital gains can be realized without disposing of the bonds.

On July 18, 2014, however, final regulations were published that fundamentally changed this beneficial result.⁵ Under those regulations, unrealized gain or loss on a position held prior to establishing an identified mixed straddle with respect to that position is taken into account at the time, and has the character, provided by the provisions of the Code that would apply if the identified mixed straddle were not established. The regulations apply to identified mixed straddles established after Aug. 18, 2014, with the result that insurers cannot use identified mixed straddles after that date to trigger capital gain recognition without disposing of assets.⁶

Taxpayers can use also “constructive sales” to trigger an embedded capital gain without actually having to sell an asset. Under I.R.C. § 1259, constructive sale treatment applies when taxpayers enter into short sales against the box⁷ or other hedges that transfer substantially all of an appreciated asset’s risk and return. In such a transaction, for tax purposes, capital gain will be recognized but not loss. Specifically, the asset will be treated as being sold at fair market value and then immediately repurchased, which results in a basis step-up and a restart of the holding period. These rules apply to stock, debt, partnership interests and actively traded trust interests.

OPPORTUNITY FOR ORDINARY DEDUCTION—PARTIAL WORTHLESSNESS DEDUCTION

Under the tax rules, a “partially worthless business debt” is deductible as an ordinary expense to the extent that the taxpayer can establish that the part claimed to be worthless cannot be recovered.⁸ Corporations subject to supervision by federal or state authorities may rely on the conclusive presumption of partial worthlessness that they charge off as required by the regulatory authority’s specific orders.⁹ In 2012, the IRS issued a directive instructing its examiners not to challenge certain partial worthlessness deductions claimed by insurance companies for credit-related charge-offs reported on their Annual Statements.¹⁰

The IRS noted that when certain securities held by an insurance company are impaired and subject to a charge-off, the company must observe certain accounting principles under NAIC SSAP 43R. Under these rules, pursuant to a charge-off, there is a reduction in the carrying value of a debt, resulting in a realized loss that is recorded on the company’s Annual Statement. The asset’s cost basis is required to be written down if the loss of principal is “other than temporary.”

In order to avail of the IRS’ safe harbor, the company’s deduction must be the same amount as the company’s SSAP 43R credit-related impairment charge-off for the same securities as reported on its Annual Statement, with a positive or negative adjustment in the first year to account for differences between the security’s tax basis and its statutory carrying value. Eligible securities for the purpose of this safe harbor are investments in loan-backed and structured securities that are within SSAP 43R’s scope and that are not “securities” as defined for tax purposes. Notably, REMIC¹¹ regular interests constitute eligible securities for this purpose.

ADDITIONAL SOURCES OF CHARACTER AND TIMING MISMATCHES

Hedging Transactions: Hedging transactions also have significant tax consequences for insurance companies. Tax hedge accounting must clearly reflect income through matching of the timing of income, deductions, gains and losses, in the hedging transaction and the item(s) hedged.¹² In general, for hedges of ordinary liabilities, any hedge gain/loss is matched to tax reserves. Gains/losses have ordinary character.¹³ Tax hedge qualification also can be important because, as discussed below, tax hedges are excepted from the straddle and mark-to-market (MTM) rules.¹⁴

To qualify for tax hedge treatment, a hedging transaction must be clearly identified as such on the taxpayer's books and records on the day it is acquired, originated, or entered into (identification for financial accounting or regulatory purposes is insufficient).¹⁵ In addition, the hedging transaction must (1) manage risk of price changes or currency fluctuations with respect to ordinary property or (2) manage risk of interest rate, price changes or currency fluctuations with respect to ordinary obligations (policy liabilities).¹⁶ Significantly, a transaction that hedges a risk relating only to a capital asset (such as an insurance company's investment assets) does not qualify for tax hedge treatment.

GAAP and statutory accounting have different standards for hedging transactions than tax. For example, GAAP and statutory accounting require that the hedging relationship be highly effective at the inception of the hedge and on an ongoing basis. Tax accounting does not specify a degree of hedge effectiveness, but requires that the hedge manage specified risks. Due to these differences, situations may arise where a company can use hedge accounting for tax, but not for GAAP or statutory accounting, and vice versa.

Duration gap hedges by insurers that relate to both capital assets and ordinary liabilities are particularly problematic under current law because of uncertainty as to whether they qualify as tax hedges. It is the IRS' position that tax hedge qualification applies to a gap hedge only if the hedge is more closely related to ordinary liabilities than to capital assets.¹⁷ Applying this standard is difficult because, by definition, a gap hedge relates to both assets and liabilities and closes the duration gap between the two. As a result, there is widespread inconsistency in insurers' and IRS auditors' application of current law.

House Ways and Means Committee Chairman Dave Camp (R-MI) released a comprehensive tax reform discussion draft on Feb. 26, 2014, that includes a proposal that would modify the definition of a qualified tax hedge to allow a hedge of a bond or other evidence of indebtedness held by an insurance company to qualify (despite the fact that such assets are otherwise treated as capital assets).¹⁸ Adoption of this proposal would allow tax hedge accounting for virtually all insurance company hedges, including gap hedges. Although this hedging proposal would be beneficial, the discussion draft stops short of solving all the problems with insurer hedges because it would preserve the character mismatch between the ordinary derivatives and the hedged capital assets. In addition,



tax reform does not appear imminent and it is unclear what changes might ultimately be included in tax reform.

Straddle Rules: Straddles are offsetting positions that substantially reduce the risk of loss on interests in personal property of a type that are generally actively traded.¹⁹ The straddle rules do not apply to tax hedges or straddles consisting solely of qualified covered call options and the optioned stock.²⁰ The rules constitute an anti-abuse regime intended to prevent deferral of income and conversion of ordinary income and short-term capital gain into long-term capital gain. Although the rules were not intended to apply to insurance company business hedges, they can nevertheless apply to those transactions.

Under the general straddle rules, loss deductions are deferred to the extent of unrecognized gains in any offsetting position.²¹ Particularly for macro hedges, these rules could result in a loss being postponed for years. Recognized gains are not deferred. If the loss relates to a position in an identified straddle (i.e., any straddle that is clearly identified as such on the taxpayer's books and records before the close of the day on which the straddle is acquired), special rules apply. Under those rules, the loss is permanently disallowed and the basis of each of the identified positions offsetting the loss position in the identified straddle is increased by a specified percentage of the loss.²²

Mark-to-Market Requirements: In certain circumstances, the Code requires that an asset be MTM and deems a sale of

Aditi Banerjee is a lawyer in the Tax Department at Prudential and may be reached at aditi.banerjee@prudential.com.

Brion D. Graber is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at bgraber@scribnerhall.com.

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at pwinslow@scribnerhall.com.

the asset to occur. For example, the Code provides that each I.R.C. § 1256 contract held by a taxpayer at the end of the tax year be treated as though it were sold for its fair market value on the last business day of the year, with any resulting gain or loss taken into account.²³ Sixty percent of any gain or loss is treated as long term, and the remaining 40 percent is treated as short term.²⁴ When the taxpayer ultimately disposes of the I.R.C. § 1256 contract, any gain or loss previously included in income as the result of marking to market must be taken into account in determining the gain or loss of the actual disposition of the asset.²⁵ The MTM rules do not apply to transactions

that qualify as tax hedges.²⁶ Interest rate swaps are not subject to the MTM rules.²⁷

CONCLUSION

Navigating the tax pitfalls in asset/liability balancing is not an easy task. Asset character and timing mismatches can, and frequently do, occur. Without coordination between the investment, hedging, and tax personnel, capital losses can expire unused, potential DTAs can be lost, recognition of hedge losses can be postponed indefinitely, and expensive conflicts with IRS auditors could result. ◀

ENDNOTES

- ¹ I.R.C. § 1211(a). Unless otherwise indicated, all I.R.C. § references are to the Internal Revenue Code of 1986, as amended (the "Code").
- ² I.R.C. § 1212(a)(1).
- ³ For many insurance companies, this issue has recently been of particular importance. As a result of the upheaval in the financial markets in 2008, many companies incurred significant capital losses in that year that could be carried forward only as far as 2013.
- ⁴ Temp. Treas. Reg. §§ 1.1092(b)-3T(a), -5T(e).
- ⁵ T.D. 9678. With the exception of the effective date, the final regulations adopt the position of temporary and proposed regulations that were published on Aug. 2, 2013. T.D. 9627; REG-112815-12.
- ⁶ The temporary and proposed regulations were initially released with an immediate effective date so that they would have applied to all identified mixed straddles established after Aug. 1, 2013. In response to concerns raised by the insurance industry, the government subsequently provided that the regulations would be effective no earlier than when finalized. Announcement 2013-44, 2013-47 I.R.B. 545. The final regulations include an effective date that is 31 days after the regulations were finalized.
- ⁷ A short sale against the box occurs when the taxpayer shorts a stock that it owns.
- ⁸ I.R.C. § 166(a)(2).
- ⁹ Treas. Reg. § 1.166-1(d)(1).
- ¹⁰ I.R.C. § 166: *LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies*, LB&I-4-0712-009 (July 30, 2012).
- ¹¹ A REMIC, or real estate mortgage investment conduit, is an entity that files an election, owns primarily qualified mortgages and other permitted investments, issues multiple classes of investor interests that meet certain requirements, and satisfies certain other requirements. I.R.C. § 860D. A regular interest is an interest in a REMIC with fixed terms that is issued on the day the REMIC issues all of its interests and that is designated as such. In addition, a regular interest generally must unconditionally entitle the holder to receive a specified principal amount and provide that any interest payments made at or before maturity will be based on a fixed rate of interest or a variable rate (to the extent provided in regulations) or consist of a specified portion of the interest payments on qualified mortgages that does not vary. I.R.C. § 860G(a)(1).
- ¹² Treas. Reg. § 1.446-4.
- ¹³ I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(a)(1).
- ¹⁴ I.R.C. §§ 1092(e), 1256(e).
- ¹⁵ I.R.C. § 1221(a)(7); Treas. Reg. § 1.1221-2(f).
- ¹⁶ I.R.C. § 1221(b)(2)(A)(i); Treas. Reg. § 1.446-4.
- ¹⁷ T.D. 8555 (preamble), 1994-2 C.B. 180.
- ¹⁸ Tax Reform Act of 2014, § 3402(a)(1). This hedging proposal was included in the discussion draft in response to concerns raised by the insurance industry with an earlier Camp proposal generally requiring derivatives to be marked-to-market, with the only exception being for qualified tax hedges. That mark-to-market proposal is included in the comprehensive tax reform discussion draft, although insurers would now qualify for the exception.
- ¹⁹ I.R.C. § 1092(c)(1), (2).
- ²⁰ I.R.C. § 1092(c)(4), (e).
- ²¹ I.R.C. § 1092(a)(1).
- ²² *Id.*
- ²³ I.R.C. § 1256(a)(1).
- ²⁴ I.R.C. § 1256(a)(3).
- ²⁵ I.R.C. § 1256(a)(2).
- ²⁶ I.R.C. § 1256(e)(1).
- ²⁷ I.R.C. § 1256(b)(2)(B).

HIGHLIGHTS FROM TAXATION SECTION SESSIONS AT THE LIFE AND ANNUITY SYMPOSIUM

By Jeffrey T. Stabach

The Taxation Section was active during the spring seminar season, sponsoring a number of sessions at the Life and Annuity Symposium in Atlanta on May 19–20. The seminar provided an excellent opportunity to network and learn from leading industry insurance tax experts. I would like to thank the presenters for sharing their insights, as well as Tim Branch and Jim Van Etten for taking the time to provide summaries of sessions they presented at the meeting.

16 PD—PRODUCT TAX UPDATE

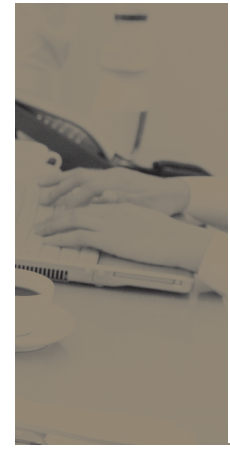
Brian King, FSA, MAAA, EY

Craig Springfield, JD, Davis & Harman LLP

The Product Tax Update session included presentations from Brian King and Craig Springfield and addressed a number of current product-related topics. The session opened with a discussion of the product-related items on the 2013-2014 IRS Priority Guidance Plan, with a focus on definition of cash surrender value under Internal Revenue Code (IRC) section 7702. Craig provided an overview of the historical definition of cash surrender value and noted specific product features that might cause concern to companies, including return of premium benefits. In addition, Craig and Brian discussed the product-related provisions in recent tax reform proposals, including a discussion of the proposed changes to the interest expense disallowance for corporate-owned life insurance (COLI) under section 264(f) and proposed reporting requirements on life settlements.

Finally, the session concluded with a discussion on the recent product-related private letter rulings (PLRs) and court cases, including:

- Recent PLRs on post-death annuity issues
- Court cases involving the tax implications of over-loaned contracts
- Recent PLRs on diversification and investor control
- Recent PLRs on modification to substantially equal periodic payments
- A discussion of *U.S. vs. Woods* and the use of the Blue Book as authority



40 PD—TAX CONSIDERATIONS FOR THE LIFE ACTUARY

Kristin Norberg, ASA, MAAA, EY

Timothy Branch, FSA, MAAA, EY

Mark S. Smith, CPA, JD, PricewaterhouseCoopers, LLP

This session, presented by Tim Branch, Kristin Norberg and Mark Smith, provided an overview of the tax concepts that apply to life insurance companies, and how reserves and other actuarial items are treated for tax purposes. Mark led off the session by providing the theory and economics of insurance company taxation, highlighting the differences between the treatment of insurance and non-insurance companies. Mark's background with the Internal Revenue Service and Department of Treasury allowed him to present unique insights into the tax authorities and Internal Revenue Code.

Kristin and Tim then presented a more detailed analysis of the definition of life insurance reserves, and how tax reserves are calculated and categorized for a life insurance company's tax return. Topics included tax reserve methods and assumptions, items taken (and not taken) into consideration for tax purposes, application of the statutory reserve cap and the net surrender value floor, and spreading of reserve method changes into taxable income under IRC section 807(f).

The session concluded with Tim, Kristin and Mark addressing various miscellaneous topics of interest to life insurance actuaries, such as the tax "proxy" DAC, taxation of foreign insurance entities and a brief discussion of the proposals in the Ways and Means Committee Chairman's tax reform plan (the "Camp draft") that affect insurance companies.

45—TAXATION SECTION HOT BREAKFAST: WASHINGTON UPDATE

John T. Adney, JD, Davis & Harman LLP

At this breakfast session, the topics discussed focused on the current legislative proposals affecting life insurance companies and policyholders. While previous sessions touched on the tax reform proposals, this session's main focus was on

CONTINUED ON **PAGE 28**

Jeffrey T. Stabach is a manager, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at Jeffrey.Stabach@ey.com.

the details surrounding the Camp draft, which offered a significant, detailed tax reform proposal. John Adney discussed how the Camp draft would potentially rewrite the rules for individuals and businesses, with specific proposed changes for life insurance companies. He gave his perspective on the prospects for the proposal, or pieces of it, being adopted. John also detailed and compared the Camp draft to provisions in the Obama Administration's budget proposals.

65 TS—INTERNAL REVENUE CODE SECTIONS 7702 AND 7702A: INTRODUCTION TO THE TAX RULES AFFECTING LIFE INSURANCE PRODUCTS

Brian King, FSA, MAAA, EY
Craig Springfield, JD, Davis & Harman LLP
Jeffrey Stabach, FSA, MAAA, EY

The Taxation Section has made an effort recently to provide more basic learning and training sessions. The goal is to provide more opportunities for younger actuaries to learn about tax related topics and to provide more information to those that have not had exposure in this area. The effort has extended to local actuarial clubs and annual industry meetings. The Introduction to the Tax Rules Affecting Life Insurance Products was a teaching session that addressed the qualification of life insurance products under IRC sections 7702 and 7702A. The session was moderated by Brian King. Brian opened up the session with a discussion of why the rules are important, and why it is important for companies to understand the rules of sections 7702 and 7702A. He discussed tax implications for policies that comply with section 7702 and the treatment of withdrawals and loans for policies that are considered Modified Endowments Contracts. Craig Springfield and Jeff Stabach walked through the qualification tests of sections 7702 and 7702A (the cash value accumulation test, guideline premium and cash value corridor test, and the 7-pay test) and the computational rules and assumptions that are associated with each test. In addition, Craig and Jeff also discussed:

- The definition of cash surrender value and premiums paid
- The definition of Qualified Additional Benefits (QABs) and the distinction between those benefits that are considered non-QABs
- The rules for administering policy adjustments
- The effect of the necessary premium exception on the 7-pay test

The session concluded with a discussion on why tax compliance is difficult for companies to administer and what they can do to limit their risk in this area.

82 PD—NO SURPRISES-TAX CONSIDERATIONS IN PRODUCT DESIGN

Jacqueline Yang, FSA, ACIA, MAAA, KPMG
Jean Baxley, KPMG
Jim Van Etten, FSA, MAAA, Van Etten Actuarial Services, LLC
Judy Jaffess, Prudential

In conjunction with the Product Development Section, the Taxation Session sponsored an in-depth session designed (1) to provide an awareness of common product tax-related challenges in the industry and (2) to outline practices and strategies to address these challenges. After Jacqueline introduced the topic, the panelists took turns providing their perspectives.

The session described the phases in the product development life cycle from initial planning to ongoing management, and pointed out that every aspect involves tax considerations. Those phases and the discussions surrounding each phase included:

1. Planning phase - where broad considerations such as evaluation of the opportunities and risks related to tax, whether the circumstances call for rulings such as a PLR, and how tax should be taken into account in pricing are considered. For the development process to be successful, it is important for tax to be included on a cross functional team.
2. Analysis phase - where the feasibility of handling tax issues is addressed by considering tax rules and related systems capabilities as part of an overall cost benefit analysis.
3. Design phase - where the product features are established in detail; in this phase, the product design should be finalized after considering recent law, regulations and guidelines, the approach to marketing and illustrating (with appropriate tax disclosures and accurate tax calculations) and administering (with software or manual processes that implement applicable tax rules) the product are defined.
4. Implementation phase - where important tax aspects, include ensuring assumptions for tax reserves and product tax rules are correct, product filings address IRS requirements where applicable, product tax training for sales

force and operations is appropriate, and that the Tax area understands how the product will be marketed and its associated risks.

5. Management phase - where important tax considerations include ongoing monitoring of tax legislative changes (with product adjustments as appropriate), monitoring of post-issue product changes (to assure there are no adverse tax impacts), technical support to operations areas, providing tax guidance in resolving customer complaints, and reviewing ongoing tax reporting to assure compliance with requirements.

Next, the panel discussed a number of product-specific tax requirements. This was followed by presentation of a number of scenarios to show instances where complaints, litigation, remediation or adverse publicity occurred, with discussion of whether/how the scenario could have had a better outcome.

Finally, the panel provided a list of better practices which should help companies achieve these better outcomes. The high level guidance from this list is that one should “Develop a robust product development process—make sure tax is involved at all of the various stages of development.” ◀



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ACLI UPDATE

By Pete Bautz and Mandana Parsazad



Pete Bautz is vice president, Taxes & Retirement Security for the American Council of Life Insurers and may be reached at petebautz@acli.com.

Mandana Parsazad is vice president, Taxes & Retirement Security at the ACLI in Washington, D.C. and may be reached at mandanaparsazad@acli.com.

Treasury and IRS released new temporary and revised final and temporary regulations to implement Foreign Account Tax Compliance Act (FATCA) on Feb. 20, 2014.¹ The Temporary and Final Regulations (TD 9657 and 9658) provided additional details and reflect changes made to the final regulations, issued in January 2013 (the “2013 Final Regulations”), to coordinate with the temporary regulations published under chapters 3 and 61 and section 3406 of the Code. These regulations contain modifications to the 2013 Final Regulations to further harmonize them with the Intergovernmental Agreements (IGAs). These regulations also revised certain provisions of the 2013 Final Regulations regarding withholding of tax on certain U.S. source income paid to foreign persons, information reporting and backup withholding with respect to payments made to certain U.S. persons, portfolio interest paid to nonresident alien individuals and foreign corporations.

ACLI had requested certain technical corrections be made to the 2013 Final. The government provided for the following items in the revised and temporary regulations:

CERTAIN FOREIGN INSURANCE COMPANIES TREATED AS U.S. PERSONS

The 2013 Final Regulations treat a foreign insurance company that is not licensed to do business in any State and makes an election under section 953(d) as a foreign person. ACLI requested that section 953(d) companies that had rulings for separate account purposes to be treated as doing business within a state, be exempted from FFI status. Specifically, we recommended that Treas. Reg. §1.1471-1(b)(132) be modified as follows:

(132) U.S. person. The term U.S. person or United States person means a person described in section 7701(a)(30), the United States government (including an agency or instrumentality thereof), a State (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof). For purposes of the preceding sentence and **subject to an exception set forth herein**, the

determination of whether an insurance company is a U.S. person is made without regard to an election by a company not licensed to do business in any State to be subject to U.S. income tax as if it were a domestic insurance company. Thus, a foreign insurance company not licensed to do business in any State that elects pursuant to section 953(d) to be subject to U.S. income tax as if it were a U.S. insurance company is not a U.S. person. **However, an insurance company electing pursuant to section 953(d) to be subject to U.S. income tax as if it were a U.S. insurance company will be treated as a U.S. person if it treats life insurance contracts and annuity contracts issued (if any) as commercial annuities within the meaning of section 3405(e)(6) subject to 6047(d) reporting.**

The temporary regulations in TD 9657 modify the definition of U.S. person to include a foreign insurance company that has made an election under section 953(d) and that either is not a specified insurance company or is a specified insurance company that is licensed to do business in any State. In such cases, the foreign insurance company will be required to continue to report on its owners in accordance with its election under section 953(d). The temporary regulations continue to treat a foreign insurance company that has made an election under section 953(d) and that is a specified insurance company that is not licensed to do business in any State as a foreign person for purposes of FATCA.

GRANDFATHERED OBLIGATIONS—DEFINITIONS—MATERIAL MODIFICATION

Section 1.1471-2(b)(2)(ii)(A)(4) of the 2013 Final Regulations grandfathered life insurance contracts from the withholdable payment rules as long as the entire contract value pays out no later than death of the insured. However, section 1.1471-2(b)(2)(ii)(B)(2) eliminates the grandfathered status for life insurance if the contract contains a substitution of insured rider. ACLI asked whether the regulations intended to exclude a population of insurance policies from grandfathering merely because they had a right to substitute the insured. We noted that if the right to substitute the insured were ever exercised, it would constitute a modification and result in a loss of grand-

fathering. Specifically, we recommended that Treas. Reg. § 1.1471-2(b)(2)(ii)(B)(2) and Treas. Reg. § 1.1471-2(b)(2)(iv) respectively be modified as follows:

(ii) Obligation.

(B) An obligation for purposes of this paragraph (b)(2)(ii) does not include any legal agreement or instrument that—

- (1) Is treated as equity for U.S. tax purposes;
- (2) Lacks a stated expiration or term (for example, a savings deposit or demand deposit, ~~a deferred annuity contract, or a life insurance contract or annuity contract that permits a substitution of a new individual as the insured or as the annuitant under the contract~~);

(iv) Material modification. In the case of an obligation that constitutes indebtedness for U.S. tax purposes, a material modification is any significant modification of the debt instrument as defined in §1.1001-3(e). *For life insurance contracts, a material modification includes any change of the insured under the contract.* In all other cases, whether a modification of an obligation is material is determined based on the facts and circumstances.

The temporary regulations in TD 9657 acknowledged our recommendation. Treasury and IRS noted that substitution of insured provisions are prevalent in existing life insurance contracts, and concluded that life insurance contracts that have such a provision should be eligible for grandfathered status until the provision is invoked.

ACLI had also requested that Treasury and IRS modify the rules under sections 6041 and 6049 related to information reporting and documentation applicable to Controlled Foreign Corporations (CFCs) of life insurance companies so they may conform to FATCA. The rules under sections 6041 and 6049 presume that payees are U.S. persons, and placed the extraordinary burden on the CFC of life insurers to collect reliable documentation to overcome that presumption in order to treat the payee as a non-U.S. person.

Treasury and IRS were responsive to ACLI's request, changed the presumption rule for CFCs and applied the chapter 4 standard for CFC chapter 61 reporting. We appreciate this change that removes a significant burden on the CFCs of life insurance companies. Updating the regulations to change the rule that allows for the presumption of individuals to be treated as U.S. only when there is actual knowledge as to accounts sold overseas is sound tax policy, levels in part the playing field for U.S. and non-U.S. owned FFIs, and is consistent with the chapter 3 and chapter 4 conformity rules in the 2013 Final Regulations. We also recommended that foreign life insurance companies that are CFCs be treated as having complied with all their reporting obligations under the Code if they fulfill the requirements of chapter 4 as proposed under FATCA for foreign life insurers. The regulations continue to require CFCs to report under chapter 61 and chapter 4. This duplication in reporting continues to place an extra burden on U.S. CFCs vis à vis their foreign-owned competitors. We continue our dialogue with the government and request clarification that the 1099 reporting rules not apply to life insurance companies prior to the July 1, 2014, effective date for chapter 4 reporting, and that chapter 4 reporting be the sole reporting for such CFCs that are life insurance companies, thus eliminating the need for Form 1099 reporting.

ACLI also submitted a letter in December 2013³ requesting that FATCA's implementation date be delayed by at least an additional six months to Jan. 1, 2015, noting that a July 2014 implementation date was too early a date for government and withholding agents alike. The letter stressed the need for final chapter 4 regulations, conforming chapter 3, 4, and 61 regulations, and final FATCA related forms and instructions before withholding agents are able to fully understand, implement and finalize changes that need to be made to policies, procedures and systems to meet their FATCA obligations.

In April 2014, Treasury and the IRS facilitated compliance with FATCA by releasing Announcement 2014-17⁴, which allowed taxpayers to treat jurisdictions that have reached agreements in substance with the United States on the terms of IGAs to implement FATCA to be treated as having agreements in effect for the remainder of 2014.

While the government did not delay the July 1, 2014 implementation date for FATCA, it provided for transitional relief

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in Notice 2014-33. Notice 2014-33 stated that “calendar years 2014 and 2015 will be regarded as a transition period for purposes of IRS enforcement and administration of the due diligence, reporting, and withholding provisions under chapter 4, as well as the provisions under chapters 3 and 61, and section 3406, to the extent those rules were modified by the temporary coordination regulations.” The IRS will take into account the extent to which foreign financial institutions and withholding agents have made “good faith efforts to comply with the requirements of chapter 4 and temporary coordination regulations.” The government made clear in the Notice that entities that have “not made good faith efforts to comply with the new requirements will not be given any relief from IRS enforcement during the transition period.”

The Notice also allows withholding agents and foreign financial institutions “to treat any obligation held by an entity that is issued, opened, or executed on or after July 1, 2014, and before Jan. 1, 2015, as a preexisting obligation for purposes of the due diligence and withholding requirements applicable to preexisting obligations.” ◀

END NOTES

- ¹ The government released its first set of technical corrections to the 2013 Final regulations in September 2013. <http://www.gpo.gov/fdsys/pkg/FR-2013-09-10/pdf/2013-22004.pdf>
They also released Notice 2013-43, which provided a six-month delay, to July 1, 2014, for FATCA withholding requirements. <http://www.irs.gov/pub/irs-drop/n-13-43.pdf>
- ² See, ACLI letters dated November 9, 2001, November 8, 2009, and April 29, 2011.
- ³ [https://members.acli.com/Committees/Committees and Informal Groups/Withholding and Information Reporting Task Force/Documents/ACLI_Letter_on_Notice_2013-43_12-26-13.pdf](https://members.acli.com/Committees/Committees%20and%20Informal%20Groups/Withholding%20and%20Information%20Reporting%20Task%20Force/Documents/ACLI_Letter_on_Notice_2013-43_12-26-13.pdf)
- ⁴ <http://www.irs.gov/pub/irs-drop/a-14-17.pdf>



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T³: TAXING TIMES TIDBITS



CIRCULAR 230 DISCLAIMERS—GONE FOREVER?

By Janel C. Frank

Following the release of new Circular 230 regulations (T.D. 9668, June 12, 2014) by the Department of Treasury, tax practitioners everywhere are wondering whether disclaimers are gone forever. Circular 230 (31 C.F.R. pt. 10) is a publication of U.S. Treasury regulations that specifies the rules governing practice before the Internal Revenue Service (IRS). Under the regulations, “practice before the IRS” includes not only the representation of taxpayers but also the provision of written advice by tax practitioners to their clients. Tax practitioners who fail to comply with the Circular 230 regulations can be subject to discipline, including censure, suspension or disbarment from practice before the IRS, and in some cases, monetary penalties. Previous articles in this publication queried whether actuaries are subject to the Circular 230 regulations. See Susan J. Hotine & Peter H. Winslow, *In-House Tax Advisors and Actuaries Beware on Product Taxation*, T3: *TAXING TIMES Tidbits*, 12 *TAXING TIMES*, Vol. 1, Issue 2 (September 2005); Susan J. Hotine & Peter H. Winslow, *Actuaries Weigh in on IRS Circular 230*, T3: *TAXING TIMES Tidbits*, 14 *TAXING TIMES*, Vol. 2, Issue 1 (May 2006).

The Circular 230 regulations were first promulgated in 1966 and have been amended numerous times since then. However, it was not until final regulations (T.D. 9165, Dec. 20, 2004) were released in 2004 that the use of disclaimers on all tax-related communications became ubiquitous. The 2004 regulations required that all “covered opinions” abide by certain standards set forth in § 10.35 of the regulations. Written advice not considered a “covered opinion” was subject to less stringent standards under § 10.37. Covered opinions included not only tax shelter opinions, but also reliance opinions, *i.e.*, the panoply of written advice that taxpayers expected to use as protection against penalties. Following the 2004 regulations, tax practitioners that wanted to provide reliance opinions were required to follow the stringent covered opinion standards set forth in § 10.35. Tax practitioners who chose not to follow the covered opinion standards or were not sure whether their written advice was subject to § 10.35 could opt out of the covered

opinion standards by including a prominent disclaimer. Under § 10.35(b)(4), the disclaimer needed to assert that the written advice “was not intended or written by the practitioner to be used, and could not be used by the taxpayer, for the purpose of avoiding penalties . . .”

The 2014 regulations (T.D. 9668) replace the covered opinion rules under § 10.35 with one standard under § 10.37 for all written advice. Tax practitioners must now (1) base all written tax advice on reasonable factual and legal assumptions; (2) reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know; (3) use reasonable efforts to identify and ascertain the facts; (4) not rely on unreasonable representations of the taxpayer or any other person; (5) relate applicable law and authorities to facts; and (6) not, in evaluating a Federal tax matter, consider the possibility that a tax return will not be audited or a tax position raised on audit. In determining whether a tax practitioner giving written advice complied with the requirements of § 10.37, the IRS will apply a reasonable practitioner standard, considering all facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client.

With the elimination of the covered opinion rules, including the disclaimer provision under § 10.35, there is apparently no longer a need to include the Circular 230 disclaimer in written tax-related communications in general. The Preamble to the 2014 regulations states as follows: “The removal of former § 10.35 eliminates the detailed provisions concerning covered opinions and disclosures in written opinions. Because amended § 10.37 does not include the disclosure provisions in the current covered opinion rules, Treasury and the IRS expect that these amendments will eliminate the use of a Circular 230 disclaimer in e-mail and other writings.”

Whether or not disclaimers remain in limited use is uncertain given that all written advice is now subject to the same reasonableness standard. The IRS Office of Professional Responsibility is on record as discouraging disclaimers that

Janel C. Frank is an associate attorney with the Washington DC law firm of Scribner, Hall & Thompson, LLP. She can be reached at jfrank@scribnerhall.com.

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assert the disclaimer is required by Circular 230 or the IRS, calling such disclaimers “misleading.” It seems more likely that the disclaimers will go the same way that they came, suddenly and universally. ◀

LB&I REVISES IDR DIRECTIVES

By Samuel A. Mitchell

The February 2014 *TAXING TIMES* edition covered the Large Business & International Division’s (LB&I’s) issuance and enforcement procedures for Information Document Requests (IDRs) contained in two Directives that were issued in 2013.¹ After the February *TAXING TIMES* edition went to press, LB&I delayed the implementation of the procedures outlined in the Directives. Then, on Feb. 28, 2014, LB&I released a revised IDR Enforcement Directive that “incorporates and supersedes” the earlier Directives in order to “clarify” the IDR enforcement process.² This administrative hiccup evidently resulted from complaints by the National Treasury Employees Union, which asserted that LB&I did not adequately consult the union before issuing Directives that remove discretion from managers and agents.³ Not surprisingly, the new Directive allows for some additional discretion on the part of LB&I managers, agents and specialists in the enforcement process. However, the new Directive still incorporates what can fairly be described as a rigid process. It repeats the admonition that the process “is mandatory and has no exceptions.”

The changes to the earlier Directives described in the February 2014 *TAXING TIMES* for the procedures agents and specialists must follow in order to issue an IDR are relatively minor. The earlier Directives did not expressly acknowledge that agents still need to issue general IDRs at the beginning of the examination seeking books and records and general information about the company. The new Directive clarifies that agents are permitted to issue the same types of general opening IDRs they have always issued. After the general IDRs are issued, however, all subsequent IDRs must be issue-focused, as previously described. In another change, the new Directive provides that the process for providing and discussing a draft IDR with the taxpayer before issuing the final IDR “should be completed in 10 business days.” The earlier Directives did not suggest or require a time period for reviewing the draft IDR. Fortunately, the new 10-day period is not mandatory; however,

agents may be inclined to read a “should” as a “must.” For this reason, tax department personnel should promptly engage the exam team regarding not only the content of an impending draft IDR but also the timing of the issuance of the draft.

The changes to the enforcement procedures add a layer in which the agents and specialists have a little more discretion in dealing with non-compliance. The new Directive still involves three steps after the enforcement procedures are triggered by non-compliance or perceived non-compliance by the taxpayer—a Delinquency Notice, a Pre-summons Letter, and a Summons. However, the new Directive gives the agent or specialist the discretion to extend the time for compliance before triggering the three-step process. If a taxpayer does not respond or provides an incomplete response to an IDR, the agent or specialist is supposed to discuss the non-compliance with the taxpayer and determine if an extension of up to 15 days from the date the extension decision is communicated to the taxpayer is appropriate. The Directive advises that the agent or specialist “should” have the discussion, make the decision, and communicate it to the taxpayer within five business days after the IDR due date.

The triggering of the enforcement process depends on whether the taxpayer does not respond to the IDR by the due date or, on the other hand, provides an incomplete response. If the taxpayer does not respond to the IDR by the due date and no extension is granted, the enforcement process begins on the date the agent or specialist communicates to the taxpayer the decision not to grant an extension. If the taxpayer does not respond on or before the due date, an extension is granted, and the taxpayer does not respond on or before the extended date, the enforcement process begins on the extended due date.

If the taxpayer provides a response, the agent or specialist must determine if the response is complete and “should” do this by the date specified in the IDR for this determination. If the response is complete, the agent or specialist must notify the taxpayer that the IDR is complete and closed. If the response is incomplete, the enforcement trigger depends on whether or not an extension is granted. If the response is incomplete and no extension is granted, the enforcement process begins on the date the decision not to allow an extension is communicated to the taxpayer. If the IDR response is not complete, an extension is granted, and the taxpayer does not provide an additional response, the enforcement process begins at the end of the extension period. If the IDR response is not complete, an extension

is granted, and the taxpayer provides an additional response, the agent or specialist must review the supplemental response for completeness and “should” complete the process “as soon as possible” or “in most cases not more than 15 business days from receipt of the response.” If after all this the response is still incomplete, the enforcement process is triggered on the day the examiner or specialist informs the taxpayer. If the response is complete, the examiner or specialist should notify the taxpayer and close the IDR.

Once triggered, the three-step enforcement process is generally the same as described in the earlier Directives. There are no changes to the third and final step, the issuance of a summons. However, perhaps because of the potential delay from the extension process discussed above, the new Directive reduces some of the compliance periods and timelines for steps one and two—the Delinquency Notice and the Pre-Summons Letter. Specifically, for step one, taxpayers have only 10 business days (subject to an extension by the Territory Manager) to respond to a Delinquency Notice, not the 15 calendar days (subject to extension by the Territory Manager) previously provided. For step two, LB&I has “generally no more than” 10 business days to issue a Pre-Summons Letter after the due date in the Delinquency Notice, as opposed to 14 calendar days. Taxpayers have 10 business days to respond to the pre-summons letter (subject to extension by a Director of Field Operations), as opposed to 10 calendar days (subject to an extension by a Director of Field Operation) previously provided.

The positive observations regarding the IDR process discussed in the February 2014 *TAXING TIMES* remain the same. The new Directive still provides that agents and specialists must identify issues for all IDRs issued after the initial IDRs in which they ask for books and records and general information about the company. Gone are the days when agents and specialists tried to use the IDR process to compel taxpayers to provide PowerPoint presentations discussing particular transactions. This may still occur for taxpayers in the Compliance and Assurance Process (CAP taxpayers) or in regular examinations for other taxpayers, but it will occur on terms negotiated by the taxpayer and only after an issue has been identified. As an aside, a CAP Q&A on the IRS website states that the requirements for issuing IDRs apply to agents and specialists examining taxpayers in the CAP process, but that the three-step enforcement process does not apply during the pre-filing phase—the enforcement process applies only

during the post-filing phase.⁴ The Q&A also states that the “CAP Memorandum of Understanding requires timely, open, cooperative, and transparent interactions between the IRS and the CAP taxpayer.”⁵ It reiterates that taxpayers who do not live up to this standard are subject to termination from the CAP program.⁶

Four recommendations made in the February 2014 *TAXING TIMES* regarding how taxpayers should deal with the new IDR process bear repeating. First, taxpayers should make it clear at the opening conference that they intend to hold the exam team strictly to the requirements for issue-focused IDRs described in the Directives. Second, taxpayers should no longer hesitate to elevate problem IDRs to higher levels of LB&I management. They should discuss in the opening conference whether specialists will be involved and verify the identity and contact information of managers who supervise the specialists. Third, taxpayers should consider requesting that IDRs that are difficult or impossible to respond to be withdrawn. The Directive does not rule this out, and it makes practical sense. No matter how much advance work is done to try to determine whether information is available and estimate how much time it will take to gather, it is very common to run into situations where it is just not feasible to meet an agreed-to deadline, either because the information is not as accessible as previously thought or does not exist. Anyone who has ever gone through the discovery phase of litigation knows this to be true. Fourth, taxpayers should assert control in the opening conference over the designation of taxpayer personnel who will be involved in the process and clarify to whom enforcement correspondence should, and should not, be sent.

It is still too early to pass judgment on the wisdom and effectiveness of the IDR issuance and enforcement process. However, the revised Directive still, on balance, represents what can be a positive development for compliant taxpayers that have good working relationships with examination teams because of the elimination of fishing-expedition IDRs. Nevertheless, problems from time to time are inevitable. The best way to avoid and resolve the problems is to emphasize effective communication between taxpayer personnel and the examination teams starting as early as possible in the examination process. Perhaps most importantly, this process of communication should extend beyond the tax department to the business people and actuaries who ultimately may be responsible for gathering the information in response to IDRs. ◀

Samuel A. Mitchell is a partner with the Washington D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at smitchell@scribnerhall.com.

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END NOTES

- ¹ Samuel A. Mitchell, *LB&I Releases Good News/Bad News IDR Procedures*, *TAXING TIMES*, Vol. 10, Issue 1 (Feb. 2014) (describing LB&I Directive No. 04-0613-004 (June 18, 2013) regarding IDR issuance and LB&I Directive No. 04-1113-009 (Nov. 4, 2013) regarding IDR issuance and enforcement).
- ² Updated Guidance for Examiners on Information Document Requests, LB&I-04-0214-004 (Feb. 28, 2014).
- ³ See Amy S. Elliott, *LB&I Delay Mandatory IDR Enforcement Procedures in Response to Criticism*, *Tax Notes Today*, 2014 TNT 27-4 (Feb. 10, 2014).
- ⁴ See [http://www.irs.gov/Businesses/Corporations/Compliance-Assurance-Process-\(CAP\)-Frequently-Asked-Questions-\(FAQs\)-Q-&A-No.-37](http://www.irs.gov/Businesses/Corporations/Compliance-Assurance-Process-(CAP)-Frequently-Asked-Questions-(FAQs)-Q-&A-No.-37). See also *id.*, Q & A 40 (noting that a summons cannot be issued before the tax return is filed).
- ⁵ *Id.*, Q & A No. 39.
- ⁶ *Id.*

IRS RULES ON THE DEFINITION OF INSURANCE BUSINESS FOR PURPOSES OF COMPUTING LICTI

By *Laura Homan*

On March 21, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling 201412001 (the PLR) regarding the characterization of an activity as insurance or noninsurance business for purposes of computing life insurance company taxable income (LICTI) under Section 806(b). One significance of the characterization of the activity as insurance or noninsurance is that in computing LICTI, a life insurance company's losses from noninsurance business, or "nonlife losses," are limited to the lesser of 35 percent of the nonlife losses or 35 percent of the life income. The amount calculated is entered on the return as an increase to LICTI in the determination of the life insurance company's total taxable income.

The taxpayer in the PLR requested a ruling that the passive investment activities of its wholly-owned nonlife subsidiary were properly treated as an insurance business following the subsidiary's check-the-box election and therefore the subsidiary's income and expenses should be included in computing tentative LICTI without the above-described loss limitation.

BACKGROUND ON THE COMPUTATION OF LICTI

Section 806(b)(3)(A) defines "noninsurance business" as "any activity which is not an insurance business." Section 806(b)(3)(B) further provides that any activity which is not an insurance business is treated as an insurance business if it is of the type traditionally carried on by life insurance companies for investment purposes but only if the carrying on of such activity (other than in the case of real estate) does not constitute the active conduct of a trade or business.

There are no Treasury Regulations interpreting Section 806(b)(3)(B)(i), nor is the term "active conduct of a trade or business" specifically defined for purposes of that section. However, the legislative history to Section 806 confirms that investment activities that are held to support contracts issued or reinsured by the taxpayer should be taken into account in computing LICTI. Further, a business that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as an insurance business so long as it is not the active conduct of a trade or business (however, real estate activities are not subject to the active trade or business standard).

FACTS STATED IN THE PLR

As discussed in the PLR, the passive investment activities were conducted by a subsidiary that taxpayer indirectly owned through members of its life insurance subgroup. The taxpayer proposed that the subsidiary, after segregating certain consulting activities in a separate company owned by the taxpayer or a non-life subsidiary, would make an election to be disregarded as a separate entity (check-the-box election). Following the election, the assets relating to the passive investment activities will continue to support life insurance and annuity contracts issued by the life insurance subsidiary.

IRS CONCLUSION IN THE PLR

The IRS concluded that the investment activities are properly treated as an insurance business following the check-the-box election. The PLR is redacted and does not describe the nature of the activities in question, other than to describe the activities as passive investment activities, and "of the type traditionally carried on by life insurance companies for investment purposes." Further, the ruling confirmed that the carrying on of the passive investment activities did not constitute the active conduct of a trade or business. As a result, the income and

Laura Homan is a Director, Federal Tax Controversy Services with Deloitte Tax LLP and may be reached at lhoman@deloitte.com.

expenses of the subsidiary should be included in computing tentative LICTI and not limited by Sections 806(b)(3)(C) or 1503(c).

The ruling sheds additional light on the meaning of “insurance business” for purposes of Section 806 and the computation of LICTI. ◀

END NOTES

- ¹ Section references contained herein are to the Internal Revenue Code of 1986, as amended (the Code). This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this publication. Copyright © 2014 Deloitte Development LLC. All rights reserved.
- ² Section 801(a) imposes a tax for each taxable year on the LICTI of every life insurance company.
- ³ Sections 806(b)(3)(C), 1503(c).
- ⁴ For a discussion of the Section 806(b)(3)(C) limitation, see I.R.M. § 4.42.4.15 (May 29, 2002).
- ⁵ H.R. Rep. No. 432, 98th Cong., 2nd Sess. 1407-1408 (1984).
- ⁶ *Id.* In a 1994 Field Service Advice, 1994 FSA LEXIS 446, the IRS applied Section 806(b)(3) to determine whether certain activities engaged in by a life insurance company constituted “noninsurance business” as defined in Section 806(b)(3), thus subjecting the losses from the enterprise to the loss limitation provisions of Section 1503(c). The IRS concluded that the nature and level of activity engaged in by the life insurance company (and its predecessor) did not constitute “noninsurance business” as defined in Section 806(b)(3), therefore the loss limitation contained in Section 1503(c) was not applicable.

SUBCHAPTER L: CAN YOU BELIEVE IT? TAX HEDGE ACCOUNTING FOR EQUITY- INDEXED UNIVERSAL LIFE INSURANCE

By Peter H. Winslow

Equity-indexed universal life insurance (EIUL) contracts typically allow the policyholder to allocate all or a portion of premiums to either a fixed account which provides for interest credited to the contract measured at a minimum fixed rate or to one or more indexed accounts which provide for interest credited at a rate determined by an equity index. This contract feature effectively provides the policyholder with an embedded equity option. Life insurance companies purchase derivatives (generally equity call options) to hedge the risks related to the policyholder’s embedded option.

Actuarial Guideline 36 (AG 36) provides several optional methods to comply with CRVM in computing statutory reserves for EIUL contracts, but many companies use the Updated Market Value (UMV) method. The UMV method applies the general approach of the Universal Life Insurance Model Regulation, but modifies the regulation to take into account the present value of the policyholder’s embedded equity option. The present value of future guaranteed policy benefits is calculated at the valuation date by projecting a fund equal to the greater of the Guaranteed Maturity Fund (GMF) or the policy value (policy accumulated value). In addition, under the UMV method, a current “option cost” at the valuation date is accumulated and added into the projected fund at the end of the current indexed segment term. The option cost for each indexed segment may be calculated using the same formula and assumptions (risk-free rate, volatility, strike price, current equity index value, time to maturity) as used to value the hedging instrument for statutory purposes. Thus, the amount taken into account for the option cost for a policy’s indexed segments under the UMV method is the indexed segment’s accumulated value at the valuation date. As a result, the option cost used in the AG 36 reserve calculation is valued consistently with, and moves with, the market value of the hedging asset. For this reason, the hedge accounting method used by many companies for statutory purposes is to mark the hedging instruments to market (MTM).

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One could assume that, because of this consistency in the valuation of the option cost under AG 36 and the MTM value of the hedge for book purposes, statutory earnings attributable to the policyholder's embedded option would not be affected by market change. But, this may not be the case; the change in reserves using the UMV method and the change in the value of the related hedges can be materially different. A major cause of the difference in the quantitative relationship between the reserves and related hedge is application of the "R-factor," a feature of the Universal Life Insurance Model Regulation. The R-factor, coupled with the treatment of option costs under the UMV method, has the effect of treating the policyholder's embedded option as a future benefit that is funded in part by future premiums, even though as a practical matter the policyholder benefits are funded by the hedge. The impact of the R-factor is most pronounced where an EIUL contract has little or no cash value and equity index values goes up. In these circumstances, the increase in statutory reserves attributable to the policyholder's embedded option can be much less than the value of the derivative used to hedge the liability. This can create a potential mismatch in statutory earnings for companies that mark-to-market their derivatives for book purposes. In that case, the full change in market value of the derivative would be included in income, but may not be offset entirely by an increase in reserves. The result would be statutory income when there is no economic income.

The R-factor is not the only reason why the MTM value of derivatives and the change in reserves can differ. Other factors may include differences in the valuation assumptions used in determining increases in corridor death benefits and the impact of the cash surrender value floor. In the case of tax reserves, the substitution of tax discount rates also can be a factor.

This income/deduction mismatch should be avoidable in determining taxable income if principles required for tax hedge accounting are followed. The first step in the analysis is to recognize that the derivatives used to hedge EIUL risks qualify as a hedging transaction for tax purposes. Section 1221(b)(2) of the Code defines a hedging transaction for tax purposes to include any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Hedges of EIUL risks are described by this definition because they are entered into "primarily to manage risk of interest rate or price

changes with respect to" life insurance contract liabilities, which are "ordinary obligations." They are ordinary obligations because the tax deductions related to the EIUL contract liabilities are not capital, but ordinary.

Once we have a hedging transaction for tax purposes, the second step in the analysis is to adopt a tax hedge accounting method that clearly reflects income. The requirement to clearly reflect income is implemented for tax hedges by section 446 of the Code and encompasses a matching requirement in Treas. Reg. § 1.446-4(b) as follows:

To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged.

Treas. Reg. § 1.446-4(c) goes on to provide that for any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear-reflection-of-income matching requirement and different tax hedge accounting methods can apply to different types of hedging transactions and different types of hedged items.

These regulations contemplate that ordinary tax rules will apply to the hedged item with the timing of recognition of gain/loss, etc., relating to the hedging instrument adjusted to match the hedged item. As a result, the regulations provide, in general, that tax accounting for the hedging transaction will supersede accounting rules that otherwise would apply to the derivatives so that proper matching to clearly reflect income occurs.

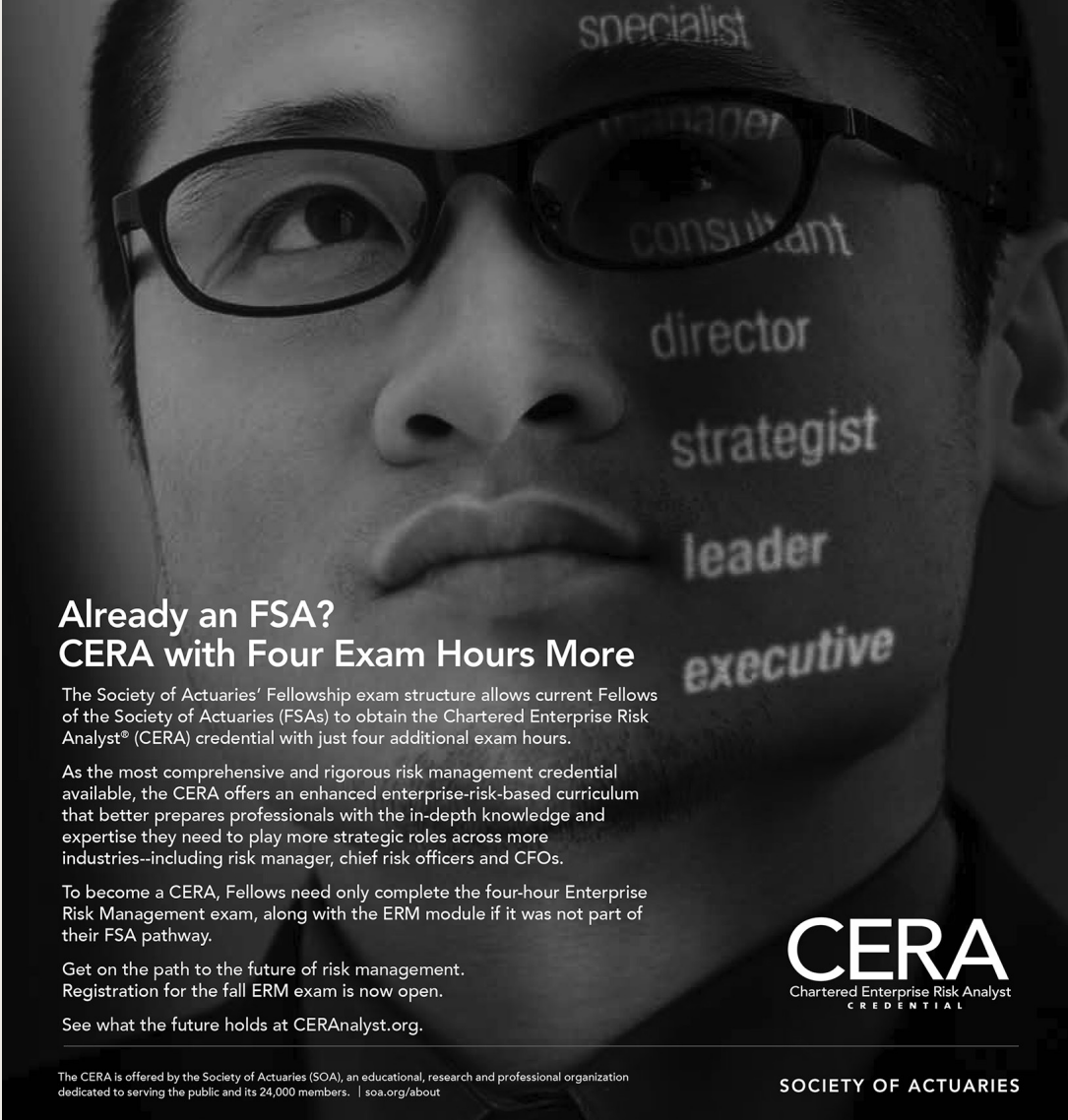
To comply with the regulations' matching requirement, the objective of an EIUL tax hedge accounting method should be to clearly reflect income by matching the timing of tax recognition of gains, losses, income and deductions attributable to the hedging instruments (the "hedging transactions," as referred to in the regulations) with the tax recognition of comparable items attributable to the hedged item. This means that the tax hedge accounting method properly starts with the hedged item, the guaranteed EIUL obligations to policyholders, and the method should apply the usual rules provided by Subchapter L of the Code. The tax recognition of the hedged EIUL obligations under Subchapter L is reflected in the increase in the portion of CRVM tax reserves computed under AG 36 attributable to the policyholder's embedded option.

When the UMV method has been adopted, the effect may be to limit the increase in EIUL tax reserves in rising equity markets as compared to the MTM value of derivatives. In recognition of this, an appropriate tax hedge accounting method could match current MTM gain recognition on the hedging instrument to the related increase in tax reserves for the policyholder's embedded option and defer recognition of any remaining MTM hedge gain to a period when this portion of tax reserves under the UMV method catches up. There would be no inappropriate taxable income under this accounting

method, in rising equity markets when there is no economic income. Derivative gain and tax reserves deductions would be matched and taxable income clearly reflected.

In short, in the case of hedge accounting for EIUL, the tax rules may give the company an opportunity to adopt the most appropriate accounting method to clearly reflect income to match hedge gain or loss to changes in tax reserves. *Can you believe it?* ◀

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at pwinslow@scribnerhall.com.



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