



SOCIETY OF
ACTUARIES

TAXATION
SECTION

Taxing Times

VOLUME 13, ISSUE 3 • OCTOBER 2017

In the Beginning... A Column Devoted to Tax Basics The Taxation of Reinsurance Transactions

By Jean Baxley and Eli Katz

- 3 **From the Chair
Where We Go From Here**
By Don Walker
- 4 **In the Beginning...
A Column Devoted to Tax Basics
The Taxation of Reinsurance
Transactions**
By Jean Baxley and Eli Katz
- 10 **Tracking the Flow of Money in a Life
Insurance Policy to Compute Cost
Basis and Distributions**
By Scott Koehler
- 16 **ACLI Update**
By Pete Bautz, Mandana Parsazad
and Regina Rose
- T³ **TAXING TIMES Tidbits**
- 18 **Negligence Penalty Imposed on
Taxpayer Unable to Show Actual
Consultation of Supporting
Authorities**
By Kenan Mullis
- 20 **Executive Orders on Regulatory
Guidance Could Affect IRS Published
Guidance**
By Mark S. Smith
- 22 **Synopsis of Issue Brief:
Claim Reserve Assumption Basis for
Long-Term Disability Policies: Use of
Date of Incurral versus Date of Issue**
By the Tax Work Group of the
American Academy of Actuaries,
Barbara Gold, Chairperson



Taxing Times

Volume 13, Issue 3 • October 2017

Published three times a year by the
Taxation Section Council of the
Society of Actuaries.

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Schaumburg, Ill 60173-2226
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This newsletter is free to section mem-
bers. Current issues are available on
the SOA website (www.soa.org).

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Publication Schedule
Publication Month: February 2018
Articles Due: Oct. 27, 2017

2017
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From the Chair Where We Go From Here

By Don Walker

Change! 2017 was going to be a year of change. And your Tax Section Council and Friends would be out front, analyzing the changes and presenting important information to our members on a timely basis.

Well, it hasn't quite worked out that way. As I write this at the end of July, the effort to reform the Affordable Care Act has apparently failed (I will decline to express an opinion over whether that was good or bad). Time spent on health care has delayed the start of tax reform. And we don't have the answers on PBR yet.

The President has signed executive orders related to streamlining regulation, and articles in this issue address their impact. This issue includes an article on tracking the flow of money in a life insurance policy to determine cost basis and taxability

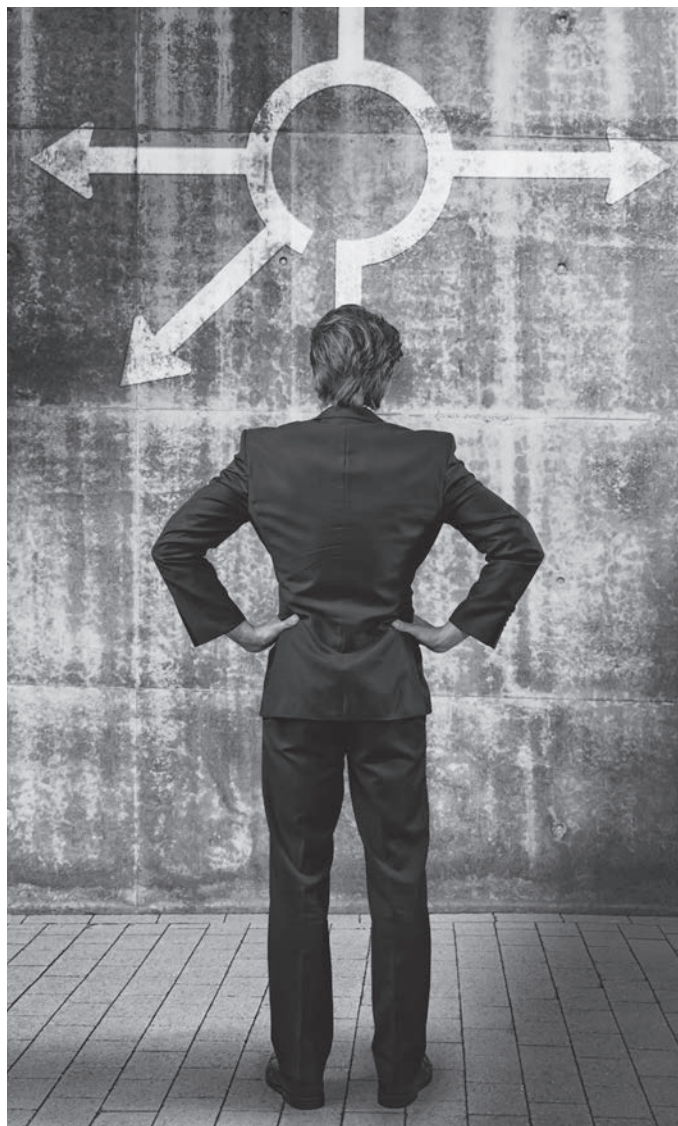
We will leverage our great assets—our volunteers who serve as council members, friends, authors and presenters.

of distributions. Our “In the Beginning...” article addresses Reinsurance Transactions. This issue is short because information remains fluid in many areas, and it is hard to write about things that may change by publication date.

By the time you read this article, we may know more. Or not.

However, regardless of how any of this turns out, our mission remains the same. We will analyze and educate, using all the means at our disposal.

We will continue to present current information through meeting sessions, webinars, podcasts, and *TAXING TIMES*.



We will leverage our great assets- our volunteers who serve as council members, friends, authors, and presenters.

It has been my privilege to serve as a leader of these volunteers, most of who know much more about some of these topics than I do. I will do what I can to continue to serve as a Friend and to support my successor.

Onward! ■

Don Walker is the retired chief life actuary at Farm Bureau Life Insurance Company of Michigan. He can be reached at dmawalker@aol.com.

In the Beginning... A Column Devoted to Tax Basics The Taxation of Reinsurance Transactions

By Jean Baxley and Eli Katz

Reinsurance involves the transfer of risk from one insurance company to another insurance company for an agreed amount of consideration. Reinsurance accounts for a significant portion of the tax complexity in the insurance industry as it allows for the transfer of a significant amount of assets and income among entities and across borders. Understanding the basics of reinsurance and its tax implications is vital to grasping the tax rules applicable to the insurance industry.

This edition of “In the Beginning” provides a high-level overview of reinsurance: its purpose and uses, its different forms, and the tax results and issues that can arise in reinsurance transactions.

REINSURANCE OVERVIEW

Reinsurance is insurance purchased by an insurance company (the “ceding company”) from another insurance company (the “assuming company” or “reinsurer”) to better manage risk and/or capital. Reinsurance provides protection for the insurer from losses as a result of insurable events covered under the reinsurance contract, which is often called a “treaty.”

From a risk management perspective, an insurance company may attempt to spread the risk from the insurance contracts it issues and reduce exposure to a particular type of risk or risk classes. Classes of risk that direct insurers transfer include mortality, morbidity, property losses due to wind, fire or flood, medical costs due to accident, policy lapse, credit quality, reinvestment, and disintermediation. For example, a life insurance company may reinsure some of its whole life policies with guaranteed cash surrender values to mitigate the risk that its pricing actuaries have underestimated mortality risk, as well as to alleviate the potential for credit losses or lower-than-expected investment returns.

Reinsurance may also be undertaken for capital and financial planning reasons, such as to acquire new business to generate growth in a more cost efficient manner, to sell non-core or underperforming businesses, to improve capital and surplus positions, or to provide for the acceleration of income to the current period. Reinsurance also enables ceding insurers to expand their capacity to write additional new business without the need to raise additional capital. Freeing up capital through reinsurance can allow companies to pay policyholder dividends as well as shareholder dividends earlier than they otherwise could have without reinsurance. These capital considerations arise from the state insurance regulatory framework which mandates that companies meet minimum risk-based capital standards, as well as the capital needed for financial strength ratings provided by rating agencies.

TYPES OF REINSURANCE: ASSUMPTION AND INDEMNITY

There are two general categories of reinsurance transactions: assumption reinsurance and indemnity reinsurance. Assumption reinsurance is permanent; indemnity reinsurance is ongoing and can be more flexible. The steps involved, and the purpose and tax results of these types of transactions differ in a number of significant ways.

Assumption reinsurance is the process of legally replacing one insurer with another through a novation¹ of the original insurance contract, thereby extinguishing the ceding insurer's liability to the policyholder. Assumption reinsurance is a significant one-time transaction which generally requires consent of policyholders and generally involves regulatory approval. Assumption reinsurance offers a means to transfer a block of business to another insurer; this may be advantageous when the company is no longer writing a particular class of business and no longer wants to devote capital to back the existing business or other resources to manage it. In addition, assumption reinsurance removes any credit risk to the ceding company related to the reinsurer's ability to satisfy its obligations, and eliminates the administrative burden on the ceding insurer of continuing to administer the policies. However, an assumption reinsurance transaction can be a time-consuming process in part because of the required regulatory and individual policyholder approvals. If any of the ceding company's policyholders object to the reinsurance company becoming fully responsible for the obligations under their policies, that remaining business would need to be managed, potentially through reinsurance on a coinsurance basis with a separate arrangement for administrative purposes.

Indemnity reinsurance, in contrast, is a contractual agreement between the ceding and assuming company which involves no requirements for notification and consent from existing policyholders. Indemnity reinsurance is an ongoing arrangement in which the reinsurer shares in the fortunes of the direct writer, and in doing so reduces the impact of individual risks for the

direct insurer. After the transaction is entered into, the direct insurer, or ceding company, is still primarily liable to policyholders; policyholders generally are not notified of indemnity reinsurance transactions. Due to its relative simplicity, indemnity reinsurance is much more common than assumption reinsurance, and it has taken on many transactional forms. These different forms of indemnity reinsurance, discussed below, have evolved as a direct result of the continuing relationship between the ceding and assuming company, which allows for the sharing of risk on an individual policy or block of business basis. The Modified Coinsurance and Coinsurance with Funds Withheld forms of agreement (described below) mitigate concerns about reinsurer credit risk—reserve credit is available when the funds to back the reserves are retained by the direct writer, even if the reinsurer’s financial strength deteriorates.

Indemnity reinsurance can be either automatic, *i.e.*, treaty reinsurance, or facultative. The key distinction is that automatic reinsurance is a broad agreement covering some portion of risk. Once the business is reinsured both parties must abide by the terms of the agreement. Facultative reinsurance, by contrast, requires the underwriting approval of the assuming company for each risk before reinsurance coverage is made available, on a policy by policy basis. The assuming company can accept or reject the risk for each policy offered.

The two major types of risk sharing in indemnity reinsurance are proportional and non-proportional reinsurance. Proportional reinsurance is the transfer of a certain percentage of risk on each individual policy. For example for each insurable event, the reinsurer will be liable for a certain percentage of the loss—or all of it. Non-proportional reinsurance is used to limit the total risk to the ceding company by the assuming company stepping in to pay the ceding company once losses exceed a certain threshold; this type of reinsurance coverage may also be called “excess loss” cover. Non-proportional reinsurance is more commonly used by non-life insurers rather than life insurers as it serves to limit the impact of catastrophic events. Stop-loss coverage is a form of non-proportional reinsurance that is written on an aggregate basis for all policies reinsured, while excess of loss cover is determined at the policy level and would only be paid when the direct insurer’s loss on an individual policy exceeds the amount specified in the reinsurance agreement.

Proportional reinsurance is more common than non-proportional in the life insurance industry.

Reinsurance agreements may take one of several forms:

- **Coinsurance**—“plain vanilla” proportional indemnity reinsurance.² In a pure coinsurance agreement, the reinsurer receives a specified portion of direct premiums and accepts the obligation to pay that same percentage of policy benefits.



- **Modified Coinsurance (Modco)**—Assets and reserves for the reinsured business remain with the ceding insurance company. Generally, with modified coinsurance agreements the reinsurer receives a “Modco Adjustment,” typically determined as an investment income credit based on the assets that remain with the direct writer, reduced by the increase in its share of reserves.
- **Coinsurance with Funds Withheld (CFW)**³—Insurance reserves transfer to the assuming company but the underlying assets remain with the ceding company. The ceding company sets up a funds withheld payable and the assuming company establishes an offsetting funds withheld receivable.
- **Yearly Renewable Term (YRT)**—The ceding company cedes mortality or morbidity risk generally with an increasing premium to reflect the yearly increase in risk. YRT may be used for large face amount policies that exceed a ceding company’s retention limit.

Under all of these types of arrangements, the reinsurer receives its defined share of premiums and settles its share of policy benefit or claims payments, and change in reserves at regular intervals, typically via a monthly or quarterly “settlement.”

CHARACTERIZATION OF REINSURANCE

For tax purposes, an acquisition transaction may be classified as assumption reinsurance in situations whereby the legal form of the transaction is a purchase of stock. Instead of obtaining policyholder approval for hundreds or thousands of policies, a corporation looking to exit a line of business may sell the stock of an insurance subsidiary that issues certain types of policies. For Federal income tax purposes, however, a section 338(h)(10)⁴ election may be made which treats the stock purchase as an asset acquisition and an assumption reinsurance transaction.⁵ This is the more common application of assumption reinsurance as a stock purchase with a section 338(h)(10) election does not require policyholder consent.

ACCOUNTING FOR REINSURANCE

Generally Accepted Accounting Principles (GAAP) and Statutory Accounting Principles (STAT) define reinsurance as a

Care must be taken in structuring a transaction to assure that it transfers sufficient risk ... otherwise, the transaction may not be treated as reinsurance.

transaction whereby risk is transferred. This topic is covered fairly extensively in other articles, specifically with respect to captive insurance companies.⁶ In short, care must be taken in structuring a transaction to assure that it transfers sufficient risk from the ceding to the assuming company; otherwise, the transaction may not be treated as reinsurance. In these situations deposit accounting must be used, which does not allow for income or loss to be recognized on the transaction.⁷ The income tax rules incorporate a similar concept to GAAP and STAT risk transfer and generally employ the same deposit accounting result in the absence of risk transfer.⁸ Deposit accounting negates the taxable income impact of the reinsurance transaction.

If sufficient risk transfer is achieved, reinsurance results in a decrease to the ceding company's reserves and assets corresponding to the amount of risk assumed by the reinsurer and the fair market value (FMV) of the assets transferred. The amount of reserves transferred at inception of the reinsurance are generally classified as premiums paid by the ceding company and premiums received by the assuming company. The ceding company's decrease in reserves constitutes income, and the reinsurer's increase in reserves is deductible as an expense.

The value of the assets transferred at inception of the reinsurance may not equal the reserves transferred, and in general the difference is a "ceding commission." Depending on the value of the policies reinsured, the ceding commission may be paid by either the assuming company or the ceding company. A ceding commission paid by the ceding company is classified as a negative ceding commission and generally occurs when an unprofitable business is reinsured. The ceding commission is reported as a separate line item from the premium income/expense. Additionally, the ceding insurer recognizes gain or loss based on the difference between the GAAP and STAT basis in the assets transferred and FMV of those assets.

The tax treatment of coinsurance is generally consistent with the accounting treatment, with some modifications. In general, a ceding company recognizes as ordinary income the decrease in tax reserves transferred and the ceding commission received from the reinsurer. The ceding company may also recognize as ordinary or capital gain or loss, depending on the category of assets, the difference between the FMV and tax basis of the assets transferred. This transfer is treated as a sale of the assets transferred subject to general income tax rules.⁹ The ceding company recognizes an ordinary deduction for the assets transferred as a premium payment, as well as any negative ceding commissions. The assuming reinsurer records premium income and obtains assets with tax basis equal to FMV.

The amount and deductibility of a reinsurance ceding commission for tax purposes can be a complex topic which depends on the classification of the transaction as indemnity or assumption reinsurance.¹⁰ For life insurers in an assumption reinsurance transaction, the ceding commission is classified as the difference between the FMV of the assets transferred and the tax basis of the reserves on the business assumed.¹¹ For indemnity reinsurance and nonlife reinsurance, the ceding commission is the net amount as agreed in the reinsurance contract, which is "grossed-up" if netted against the premiums paid.¹²

Ceding commissions paid are generally capitalized in life assumption reinsurance transactions, which include section 338(h)(10) elections as discussed above. The ceding commission that is capitalized is the amount in excess of deferred acquisition costs (DAC) capitalized under section 848.¹³ Ceding commissions in indemnity reinsurance agreements, on the other hand, are generally deductible unless they fall under a separate tax rule. Items that may override the deductibility of ceding commissions include: the transaction qualifies under Subchapter C as a tax free reorganization or capital contribution; or the transaction qualifies as an applicable asset acquisition (sale of a business) under section 1060, which could cause the ceding commission to be considered an intangible asset to be capitalized and amortized over 15 years.

POSSIBLE TAX COMPLEXITIES

Due to the introductory nature of this article, certain reinsurance-related issues are identified and briefly discussed below. Fuller discussion of these topics is left for another article or articles.

DEFERRED ACQUISITION COSTS (DAC)

Section 848 requires a “proxy” capitalization of policy acquisition costs based on a percentage of net premiums on “specified insurance contracts.”¹⁴ Specified contracts are separated into annuity, group life, and “other” and are capitalized at 1.75 percent, 2.05 percent, and 7.7 percent, respectively. These capitalized costs are amortized over either 60 or 120 months.¹⁵ Premiums written must include premiums assumed and ceded under reinsurance agreements. Thus, the ceding company reduces the amount of DAC capitalized by its premiums ceded and the assuming company increases its DAC capitalized by the premiums assumed. The Code and regulations include specific rules to ensure the net amount capitalized between the ceding and assuming parties in a reinsurance transaction is zero so no DAC is “eliminated” through reinsurance.¹⁶ An election under Reg. section 1.848-2(g)(8), which states that companies will compute DAC without regard to the general deduction limitation, is often included in life reinsurance treaties. The purpose of the election is to ensure the zero net impact intended by Congress.

An additional complexity exists with respect to reinsurance whereby an insurance company that cedes significant assets in a certain taxable year could record a net negative consideration for the year. For instance a situation could occur whereby the negative consideration could not be used to offset any prior year positive DAC, and that negative DAC could not be deducted but rather would need to be carried forward to offset future positive capitalization.¹⁷

No reduction of DAC for premiums written is allowed for reinsurance ceded to foreign insurance companies.¹⁸ The premise of this rule is that the foreign insurance company is not subject to DAC capitalization and thus the reduction in DAC for the ceding company would not be offset by an increase in DAC at the assuming company.¹⁹

SECTION 845

The IRS has the authority under section 845(a) and (b) to disallow a deduction for premiums ceded if it determines a related party transaction has a tax avoidance or evasion effect, or if any reinsurance transaction, not limited to related party transactions, has a “significant tax avoidance effect,” respectively. The IRS has challenged reinsurance transactions under this provision in the past with little success.²⁰ Companies may seek to obtain transfer pricing reports to support the arm's-length pricing of the related party reinsurance transactions.

REINSURANCE BETWEEN U.S. AND FOREIGN COMPANIES

Some items of complexity in the cross-border reinsurance context include:

- **Related Person Insurance Income (RPII)**—Reinsurance from a U.S. insurer to a foreign affiliate could result in RPII. RPII is considered Subpart F income under section 953(c)(2). In addition, the threshold for qualification as a CFC is modified to U.S. persons owning any stock, without regard to 10 percent shareholders and voting shares requirement, and substituting 25 percent or more U.S. shareholders instead of more than 50 percent for insurance companies with RPII.²¹
- **Excise Tax**—Section 4371 establishes a 1 percent excise tax on premiums paid to a foreign insurance company on reinsurance of U.S. risk. Some uncertainty exists with respect to different reinsurance transactions and the definition of “premiums paid.” For example, Modco and CFW do not involve a transfer of assets and thus may be interpreted as not having premiums paid for excise tax purposes upon commencement of the reinsurance treaty.²²
- **Section 953(d) entities**—Foreign insurance company subsidiaries of U.S. parented groups may make an election under section 953(d)(1) to treat the foreign affiliate as a U.S. company for federal income tax purposes. This election is made to avoid the income of the foreign insurance company from being subject to both Subpart F taxation and the section 4371 excise tax. Section 953(d) companies oftentimes incur losses in earlier years, which are subject to the dual consolidated loss limitation on the ability of the consolidated group to use these losses.²³
- **U.S. trade or business**—Inbound U.S. insurance companies (*i.e.*, U.S. insurance companies owned by foreign parents) may reinsure policies written on U.S. risk to foreign affiliates without being subject to Subpart F income (although these premiums are subject to the excise tax). Companies should take care to ensure they do not cause the foreign affiliate to qualify a U.S. trade or business under the Code or a permanent establishment (PE) under a tax treaty with the U.S. The analysis of whether a company has a U.S. trade or business or a PE is based on the company's specific facts and circumstances, including, as an example, a U.S. ceding company acting on behalf of the foreign affiliate as an agent with the sole purpose of reinsuring business to the affiliate.

REINSURANCE INVOLVING THE TRANSFER OF STOCK AS CONSIDERATION

In some reinsurance transactions, the ceding company receives stock in exchange for the assets and reserves that are transferred to the reinsurer. Some uncertainty exists whether the transaction would be governed by Subchapter L (insurance

rules) or Subchapter C (general corporate reorganization rules). The IRS has ruled in several instances that if a transaction qualifies for one of the tax-free transfers under Subchapter C, then Subchapter C rules control and the transaction qualifies for tax-free treatment.²⁴ To the extent the transaction does not qualify for tax-free treatment, the value of the stock transferred must be taken into account in the amount of consideration received by the ceding company.

SECTION 1060 ASSET SALES

Ceding companies often reinsure entire blocks of business. In these situations, an analysis as to whether a section 1060 “applicable asset acquisition” has occurred is required. A section 1060 transaction generally requires the capitalization of any intangibles purchased in the transaction. Ceding commissions under assumption reinsurance are generally treated as intangible assets under section 197(f)(5) and so must be capitalized and amortized over 15 years.

The IRS has asserted that an indemnity reinsurance transaction that qualifies under section 1060 would require the capitalization of ceding commissions.²⁵ Commentators have disagreed with the IRS due to the plain language of section 848(g) which states that “[n]othing in any provision of law (other than this section or section 197) shall require the capitalization of any ceding commission incurred on or after September 30, 1990, under any contract which reinsures a specified insurance contracts.” Section 197(f)(5) specifically applies only to assumption reinsurance²⁶ and section 848 is silent on whether capitalization of ceding commissions is required for indemnity reinsurance transactions.

OPERATION OF THE CONSOLIDATED RETURN RULES

Many reinsurance transactions occur between members of a group which files a consolidated tax return. The matching and acceleration rules in Reg. section 1.1502-13 govern the treatment of these reinsurance transactions.²⁷ To the extent the income and expense items for the transaction offset each other, the reinsurance transaction is respected and the income and expense items are recognized at each separate entity. For example: premium expense and premium income, change in reserves,²⁸ and DAC are all items that would generally be reflected in taxable income at the time of the transaction.

The ceding commission in an indemnity reinsurance transaction is recognized immediately. The ceding commission in an assumption reinsurance transaction is generally deferred due to the fact that the assuming company must capitalize it. As the assuming company amortizes the ceding commission over 15 years, the ceding company recognizes the income from the ceding commission.

Another intercompany item of income or loss that is generally deferred is the ceding company’s built-in gain or loss on the

assets transferred. This deferred income or expense would be recognized at the time the entities or the assets transferred are no longer part of the same consolidated return.

ACCOUNTING FOR INCOME TAXES: ASC 740 & SSAP 101 IMPLICATIONS

Complexities abound with respect to accounting for income taxes from reinsurance transactions. A significant sale of assets requires an accurate calculation of current tax expense and recognition of existing deferred tax assets and liabilities. Also, the recording of separate entity impacts of transactions between members of a consolidated return can be complicated and burdensome to track. Finally, companies may use reinsurance transactions as a tax planning tool for purposes of their valuation allowance and SSAP 101 admissibility calculations. The ability of reinsurance transactions to generate significant one-time income lends itself to tax planning considerations. Care must be given to whether these reinsurance transactions are prudent and feasible.

IN CONCLUSION

This article has sought to provide an overview of the purpose, types, and treatment of reinsurance transactions so that readers will be able to identify tax issues and areas of further research when encountering reinsurance transactions. Reinsurance is a topic to which tax professionals can add significant value by mitigating risk and providing guidance as to tax-efficient transaction structures.

Disclaimer: The article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader’s particular situation. ■

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ENDNOTES

- 1 Novation is an agreement to replace one party to an insurance or reinsurance agreement (ceding company) with another insurance company (reinsurer) from the inception of the coverage period.
- 2 Unless otherwise noted, the accounting and tax treatment of indemnity reinsurance described below apply to coinsurance.
- 3 Modco & CFW are often used to allow a ceding company to take a reserve credit for reinsurance with a foreign or unauthorized reinsurer. Insurance regulators generally do not allow a reserve credit if assets are transferred to foreign or unauthorized reinsurers under the premise that satisfaction of the reinsurer's contractual obligations would not be sufficiently assured. When the ceding insurer retains the assets that support the ceded business, the regulators can be assured the assets will be available to satisfy policyholder obligations. Historically, insurance companies were required by regulators to transfer the assets backing the reinsured reserves into a trust to satisfy insurance regulators. However, more recently Modco and CFW have been used without the need for a trust.
- 4 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.
- 5 Reg. section 1.338-11(c).
- 6 Captives generally insure or reinsure the risk of the captive's owner(s) and affiliates. They provide a method for self-insuring or for pooling risks with other companies without the use of third party insurers. The popularity of captives has increased in the past two decades and they are now used for many types of risks. Life insurers also use captive reinsurance companies for certain types of products for surplus relief. See further discussion on captive developments in Logan R. Gremillion, *Beyond Safe Harbors: Recent Developments in Insurance & Risk Distribution*, 56 *Tax Management Memorandum* 253 (July 13, 2015).
- 7 See ASC 340-30 and SSAP 61 Paragraph 17.
- 8 CCA 201503011 (January 1, 2015) which states, "In limited circumstances, where an arrangement purporting to be insurance is not insurance for federal income tax purposes, the arrangement may still support a deduction under section 162 as an ordinary and necessary business expense for the parent's payment of the premium and inclusion of the amount of the premium in the captive's income under section 61. Any losses paid by the captive, in that case, would be deductible to the captive when paid, and not before because, as stated in Rev. Rul. 2007-47, 2007-30 I.R.B. 127, "[i]f an arrangement is not an insurance contract, no reserves are permitted for unearned premiums or for discounted unpaid losses with respect to the arrangement."
- 9 *E.g.* sections 1001 (sale of capital assets), 1045 (ordinary income recapture), 1276 (accrued market discount recapture).
- 10 Reg. section 1.809-5(a)(7)(ii) defines assumption reinsurance for tax purposes.
- 11 Reg. section 1.817-4(d) prescribes the income tax treatment of assumption reinsurance.
- 12 See Rev. Rul. 70-552, 1970-2 CB 141, which states "Further, the accrual of the foregoing rights and obligations and their treatment for Federal income tax purposes are not affected by the fact that the primary insurer 'netted out' the ceding commission against the pro rata gross premium so that only a net amount was paid to the taxpayer."
- 13 Section 197(f)(5).
- 14 For a more detailed discussion of DAC see Stephen Baker, "In the beginning ... A Column Devoted To Tax Basics, Tax DAC," *TAXING TIMES*, Vol. 13, Issue 1 at 8 (February 2017).
- 15 Premiums on reinsurance contracts are only amortized over 120 months under section 848(b)(4).
- 16 Section 848(d)(4)(A).
- 17 Section 848(f) and Reg. section 1.848-2(i)(2), (3).
- 18 Reg. section 1.848-2(h)(1).
- 19 An election is available under Reg. section 1.848-2(h)(3) to compute DAC for foreign reinsurance separately. The mechanics of the election would allow any net negative consideration on foreign reinsurance to offset future net positive consideration on foreign reinsurance.
- 20 See *Trans City Life Ins. Co. v. Commissioner*, 106 T.C. 274, 302 (1996) (holding that the IRS abused its discretion when it determined that a reinsurance agreement among two unrelated insurers had a significant tax avoidance effect), compare *FAA 20092101F* (May 22, 2009) (concluding that the proposed tax treatment of a reinsurance transaction between two related parties should be disallowed under section 845(b) because it had a significant tax avoidance effect).
- 21 Section 953(c)(1).
- 22 For further commentary on this topic see Brion D. Graber, *Determining "Premiums Paid" For Purposes Of Applying The Excise Tax To Funds Withheld Reinsurance*" 78 *Reinsurance News*, 14 (March 2014).
- 23 Section 953(d)(3).
- 24 See Rev. Rul. 94-45, 1994-2 CB 39 (assumption reinsurance), *PLR 201511015* (March 13, 2015) (concluding that the indemnity reinsurance transaction did not qualify under section 351 for tax free treatment and thus Subchapter L was applicable); *PLR 201506008* (February 6, 2015) (concluding that an indemnity reinsurance transaction in exchange for stock can qualify under section 351 as a tax free contribution due to the permanence of the reinsurance agreement).
- 25 CCA 201501011 (January 2, 2015) clarified by CCA 201642032 (October 14, 2016) in which the IRS recharacterized the transaction as assumption reinsurance for tax purposes to reach the same conclusion. "We have reconsidered our analysis and now conclude that, in a section 1060 acquisition, the section 338 regulations apply with respect to the basis allocation rules only and do not treat the acquisition of insurance contracts as an assumption reinsurance transaction."
- 26 For a more in depth analysis of the treatment of ceding commissions in the context of whether they are deductible or capitalized see William Pauls, "IRS Assumes Away Inconvenient Law in Reinsurance CCA," 147 *Tax Notes* 277 (April 20, 2015).
- 27 Reg. section 1.1502-13(e)(2)(ii)(B)(1).
- 28 An exception exists for reserves to be calculated on a separate entity basis whereby the assuming company may calculate reserves differently than the ceding company and that difference in reserves is recognized currently.

Tracking the Flow of Money in a Life Insurance Policy to Compute Cost Basis and Distributions

By Scott Koehler

I am an information technology professional with over 25 years of experience designing and building life insurance policy taxation systems with many life insurance companies. Over the years I have worked with product tax actuaries and tax attorneys in this pursuit. In this article I discuss how including the intent and rationale of the tax law when translating the law into specifications for coding tax systems can improve the system design, reduce system complexity, and achieve flexibility and maintainability.

This article will illustrate the approach by introducing the concept of tracking the “flow of money” in a life insurance policy when processing policy level transactions. Analyzing the flow of money in a policy provides a method for calculating cost basis and determining distributions from the policy.

BACKGROUND

As John Adney discussed in the June 2017 issue of *TAXING TIMES*, “investment in the contract” and “basis” are fundamental concepts to the taxation of life insurance products. These values are essential in determining if there is a tax liability due to a specific transaction on a life insurance policy. Calculating and maintaining an accurate cost basis for a policy is one of the most important tax processing functions in the administration of a life insurance policy. The policy’s cost basis directly affects whether a distribution from the policy’s investment in the contract is taxable to the policy owner.

In my experience, the best approach for computing cost basis for the administration of a life insurance policy is to establish a separate data field for tracking cost basis that is stored with the other policy values, rather than attempt to derive it when needed from other values available for the policy.¹ There are many different situations when processing transactions for a policy that can occur that impact cost basis. It would be onerous to try to recreate all of these events at a later point if deriving cost basis from other values. For each transaction



processed for the policy, the running total for cost basis is adjusted (up, down or no change) based on the impact that transaction has on the cost basis. Cost basis can be impacted by many different types of policy transactions, including premium payments, withdrawals, partial surrenders, monthiversaries, and dividends.²

If a distribution subject to taxation occurs for a policy and an amount is deemed taxable, then a 1099-R tax form is used to report the taxable distribution to the policy owner.³ Box 1 provides the gross distribution, Box 2a is the taxable amount, and Box 5 is used for the “employee contributions,” *i.e.*, cost basis. For example, a \$25,000 (Box 1) withdrawal from a non-MEC life insurance policy where the cash value was \$60,000 and cost basis was \$20,000 (Box 5) would result in a taxable amount of \$5,000 (Box 2a).

The calculations behind the scenes to arrive at these figures are often quite complicated and require the utmost accuracy. Like most life insurance policy taxation system business requirements, the “devil is in the details.”

INTENT OF THE LAW

When writing business specifications for tax system processing, it is helpful to understand and document the intent and rationale behind sections of the tax law in specifications and to focus on “what” processing is required—instead of “how” the processing is to be performed. Including this information in the business specifications facilitates the development of appropriate design solutions and allows system developers to construct solutions in a more flexible manner.

I worked with a product actuary who often said that he tried “not to lead the programmer” in his specifications. He did not want to provide the detailed method for coding the system. Rather, the software professionals trained in various design techniques could utilize different approaches while working with the specification author to achieve the desired system result. Detailed technical specifications would identify “how” the system would accomplish the processing. Modern computer languages provide various capabilities to facilitate modeling insurance policies and their components that simplify coding.

As an example, consider the intent of the reduction in benefit testing requirement, in Internal Revenue Code section 7702A(c)(2)(A). The intent of this rule is to prevent a policyholder from purchasing a policy with high benefit amounts in order to set a high 7-pay premium limit, then depositing money up to the limit, and then sometime later reducing the policy benefits to make it more affordable. The requirement to retest as if the lower level of benefits were present since the beginning of the 7-pay testing period is challenging for a policy administration system which processes transactions chronologically.

There are a variety of possible system solutions that could be considered to achieve this requirement in a system (including manual intervention) and I have seen several of them in practice. Some solutions are much more difficult to implement than others. Identifying the intent of the law and describing what processing is required encourages consideration of design alternatives that provide the best overall solution.

Regarding “investment in the contract,” the tax law is concerned with how much money has been contributed to the investment in the contract and the current value of those contributions in the policy, *i.e.* cost basis. Distributions from the contract are evaluated for taxation based on the policy’s gain, cost basis, and taxation method (*e.g.*, gain first, cost recovery first, etc.).

The tax law does not speak to a specific insurance company’s products or detailed product designs like specific riders, benefits, features, or dividend options. An insurance company’s detailed tax interpretation must consider the company’s product designs and policy features in formulating system specifications. While it is tempting to write explicit specifications for system development referencing how to handle all of the products and product complexities in scope, this can lead to very complex system coding with considerable redundant logic, onerous testing requirements, and a brittle system.

As an alternative, consider a more general approach when developing business specifications. Include the intent and rationale of the tax law and author rules more at the conceptual level. Also, provide detailed examples that are helpful for demonstrating calculations.

To illustrate, when considering the rationale behind how a life insurance policy is taxed, analysis leads to identifying four section 72(e) categories for interpreting components of a life insurance policy, as shown in Table 1.

Table 1

Section 72(e) Category	Description	Possible Policy Components ⁴
Investment in the Contract	Considered part of the tax law’s “investment in the contract”	The base policy, investment accounts ⁵
Inside the Contract	Recognized by the tax law as part of the policy, but not part of the investment in the contract	Specific type(s) of riders, benefits, or features
Outside the Contract	Considered outside the contract for tax law purposes, but may be administered with the contract for the convenience of the policyholder	Specific type(s) of riders, benefits, or features, dividend accumulation account, an outstanding policy loan ⁶
Outside the Company	Money that leaves the policy and insurance company	A check mailed to the policy owner

As transactions are applied to the policy, the flow of money is tracked between the components of a policy and key tax values are updated appropriately. The “flow of money” in and out of the investment in the contract is essentially what matters to the tax law. The business specifications for the system can be written in a more general, conceptual manner. For example:

- Money flowing to components of the policy considered Investment in the Contract would be included in cost basis. That is, cost basis would be increased by money flowing into these components.⁷
- Money flowing out of Investment in the Contract components to Outside the Contract or Outside the Company components would, in general, be considered a distribution subject to possible taxation. This could result in a taxable amount and/or reduction in cost basis.⁸
- Money flowing to the other section 72(e) categories would not increase cost basis and flows out would not be distributions.
- Money flowing within the components considered Investment in the Contract would not be a distribution or have any impact on cost basis. For example, an exchange from one

investment account option to another investment account option or a dividend earned by the base policy used to purchase paid up additions would not result in a distribution subject to taxation or cost basis update.

Also included in the specifications would be a list of all policy components where each component would be identified with the section 72(e) category that applies for that component. For example, the base policy would be identified as Investment in the Contract, the dividend accumulation account would be Outside the Contract, etc. This information can be designed to be included in a separate data file that is readable by the tax system which allows for easy update.

Designing and coding the system in a more general way avoids a lot of transaction specific tax logic.⁹ Table 2 provides a list of specific policy transaction activity and how the general tax processing logic would handle it.

It should be noted that a similar approach of arriving at categories for components of a policy would apply to other areas of the tax law as well. For example for section 7702A, components of a policy could be classified as a TAMRA Death

Table 2

Policy Transaction Activity ¹⁰	Money Flow	Tax Processing
Payment of a normal premium by payor	From Outside the Company to Investment in the Contract	Increase cost basis
Withdrawal from policy’s investment account with check to policy owner	From Investment in the Contract to Outside the Company	Distribution subject to taxation, Cost basis reduced and/or taxable amount
Dividend paid with check to policy owner	From Investment in the Contract to Outside the Company	Distribution subject to taxation, Cost basis reduced and/or taxable amount
Dividend paid to accumulation account	From Investment in the Contract to Outside the Contract	Same as dividend paid with check above
Dividend paid for loan interest	From Investment in the Contract to Outside the Contract	Same as dividend paid with check above
Surrender of dividend accumulation account with check to owner	From Outside the Contract to Outside the Company	No additional tax impact (the tax impact was recorded when the dividends were applied) ¹¹
Premium payment made from dividend accumulation account	From Outside the Contract to Investment in the Contract	Increase cost basis
Monthiversary	Charges deducted from the Investment in the Contract to pay for benefits Outside the Contract	Distribution subject to taxation, Cost basis reduced and/or taxable amount
An exchange from one investment account option to another	From Investment in the Contract to Investment in the Contract	No impact ¹²

Benefit, Qualified Additional Benefit, etc., and specifications would be written accordingly.

EXAMPLE

To illustrate how the detailed calculations are performed at the system level, consider an example from dividend paying life insurance. Policies that pay a dividend have certain dividend options that define how the dividend is to be applied. Dividend options often include the following type of options:

- Reduce the policy premium
- Pay in cash
- Accumulate at interest
- Purchase paid up insurance
- Pay loan interest

In addition, many complex dividend options exist that combine several of the primitive options above—for example, Reduce Premium, then Pay (the remainder in) Cash.

Applying the flow of money concept for a policy level transaction that applies a \$100 dividend earned from the base policy to the dividend accumulation account yields the results seen in Table 3.

This results in a distribution subject to taxation of \$100 that leads to either a reduction in cost basis and/or taxable gain amount.¹³

Consider a more complex, contrived example, where a “super” dividend option is in effect on a policy and a policy level transaction applies the \$100 dividend earned from the base policy and \$10 dividend earned on paid up insurance from dividends. The \$110 total dividend is applied as follows: \$50 to reduce the premium, \$25 to buy paid up insurance, \$20 to pay loan



interest, and \$15 to accumulate at interest. This would be handled by the system as seen in Table 4.

In this example, the Investment in the Contract sees a reduction of \$110 from paying the dividend. This is offset by \$75 reinvestment in components that are also considered Investment in the Contract. The result is a net distribution of \$35 which would either reduce the policy’s cost basis and/or be treated as a taxable gain amount depending on the cost basis, cash value, and taxation method in effect for the policy.

Table 3

Policy Component	Section 72(e) Category	Outflow	Inflow	Impact on Investment in the Contract
Base policy	Investment in the Contract	-100		-100
Dividend accumulation account	Outside the Contract		+100	0
Net distribution				-100

Table 4

Policy Component	Section 72(e) Category	Outflow	Inflow	Impact on Investment in the Contract
Base policy	Investment in the Contract	-100	+50	-50
Paid up insurance from dividends	Investment in the Contract	-10	+25	+15
Loan interest	Outside the Contract		+20	0
Dividend accumulation account	Outside the Contract		+15	0
Net distribution				-35

In the examples above the calculations are performed without any specific references to particular dividend options, that is, there is no IF THEN rule stating “IF Dividend Option 1 applies THEN do this...” Alternatively, the calculation is performed by detecting where the money flows after the transaction is applied to the policy. Avoiding direct references to detailed product specifics (like dividend option types) reduces system complexity and improves maintainability.

As mentioned earlier, the same concept can be applied to other tax related calculations like tracking money that is included in the guideline premium test (guideline premiums paid) and 7-pay test (amounts paid).

CONCLUSION

The tax law applicable to life insurance policies has underlying intentions and rationale. It is written without any specifics of particular insurance policy designs. An insurance company’s interpretation of the tax law takes into account the company’s

products. Including the intent and rationale of the tax law in business specifications and focusing on what the system must do, rather than how to do it, enables more robust system designs. This leads to less complex coding and testing, and the system will be more resilient to change.

Disclaimer: The information contained herein is provided for informational purposes only and not for purposes of providing any professional advice. Applicability of the information to particular situations should be determined by your tax advisor. ■

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ENDNOTES

- 1 Separate policy level data fields are also recommended for other running totals of money like “amounts paid” (section 7702A) and “guideline premiums paid” (section 7702), since some of the rules for accumulating these values differ from cost basis.
- 2 Some additional scenarios where specific types of transactions can impact the cost basis of a policy include:
 - a. loan or loan capitalization transactions where the new loan includes a distribution subject to tax (due to the policy being a MEC)
 - b. lapse transactions for policies with outstanding loans where the policy value supporting the loan amount is treated as a distribution and taxed accordingly
 - c. policy change transactions where money is disbursed or if the policy becomes a MEC when processing the transaction and the two-year look back results in the need to determine a tax liability for a prior transaction
 - d. surrender transactions for policies with an outstanding loan or 1035 exchange surrender transactions for policies with an outstanding loan or recent prior distributions
- 3 Normal taxable distributions are reported with a distribution code = 7. Other distribution codes are used to report other activity like early distributions, 1035 exchanges, or Long Term Care rider charges, for example. Form 1099-R and the related instructions are available at irs.gov.
- 4 Examples of possible interpretations for policy components are provided to help illustrate the concepts, not for purposes of providing any professional advice. As John Adney noted in the June 2017 issue of *TAXING TIMES*, the manner of treatment of benefit riders for section 72 is a subject worthy of additional discussion. An insurance company’s classification of their various benefit riders would be stated in the company’s tax specifications.
- 5 Investment accounts, as used in this article, refer to the separate account(s) maintained for the policy for the investment of the policy values. Various investment accounts may be created in the administration of the policy (e.g., the cash value of a universal life policy or a loan collateral account when a policy has an outstanding loan). The investment account for a variable life policy may contain a number of investment account options (sub accounts) which are elected by the policy owner.
- 6 The term “loan” can be considered both a verb and noun. A loan transaction performs the action of borrowing money (the verb) which results in an increase in the outstanding loan liability amount (the noun). Normally taking a new loan is not considered a distribution, but it is a distribution for policies that are MECs. The outstanding loan liability that results from a loan transaction is considered Outside the Contract in that actions performed for servicing the loan like the payment of loan interest or loan payments to reduce the loan amount are considered Outside the Contract.
- 7 In practice, there are some exceptions to these general rules. For example, payments from incoming 1035 exchanges will provide a carryover cost basis from the previous policy.
- 8 There are a variety of rules that determine if a distribution subject to taxation is taxable including whether the policy is in a gain situation, the policy’s MEC status, the current cost basis, etc. Some riders receive special treatment.
- 9 In general, I recommend that the majority of the tax processing system logic should not be directly tied to transactions. The tax law is largely transaction agnostic. For instance, in section 7702A(c)(2)(A), the tax law states that “if there is a reduction in benefits under the contract within the 1st 7 contract years...,” however, the tax law does not stipulate what type of policy transaction may have caused that reduction in benefits to occur. Many insurance policy administration systems have separate transaction processing modules that contain detailed processing logic for handling each type of transaction. Building specific tax logic within the transaction modules can reduce flexibility.
- 10 Policy transaction activity examples are representative of transactions that occur on a variety of types of life insurance policies (e.g., whole life, universal life, variable life, etc.).
- 11 The interest credited to the dividend accumulation account is taxable and reportable when paid.
- 12 Some transactions may result in no tax impact, but that does not suggest skipping the transaction entirely in tax processing. Rather, a transaction can still be processed for tax testing that nets to zero in some tax calculation. Opting to skip administrative transactions for tax processing can lead to problems later when the law or interpretation changes occur that require processing that type of transaction.
- 13 In general, cost basis is reduced by any non-taxable distributions. For system processing consistency, I prefer a three-step method to arrive at the updated cost basis. First, determine the distribution subject to taxation. Second, determine the taxable amount (if any) based on the policy’s cost basis, MEC status, etc. Third, adjust the cost basis down by the distribution amount and up by the taxable amount. In this example, the investment in the contract may end up remaining the same if the entire distribution is taxable.



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ACLI Update

By Pete Bautz, Mandana Parsazad and Regina Rose

REGULATORY GUIDANCE UPDATE

In the past several months, ACLI submitted letters to the Internal Revenue Service (IRS) with recommendations on guidance projects, and on proposed and final regulations affecting the life insurance industry. The first letter, submitted on June 1, was in response to Notice 2017-28, which sought public input on the IRS 2017-2018 Priority Guidance Plan (PGP). The second letter, submitted on July 31, was in response to a Request for Information (RFI) issued by the U.S. Department of the Treasury (Treasury) on June 14, seeking input on executive orders issued by President Trump regarding regulations that may be modified, streamlined, or withdrawn.¹

In the June 1 letter, which singled out four issues for guidance, ACLI continued to advocate for issuance of previously-identified guidance needed on Life Principles-Based Reserves (Life PBR), highlighting two distinct categories of sub-issues in need of guidance: (i) reserve transition issues, and (ii) substantive reserve issues. The industry continued to characterize life PBR as the industry's highest priority.

The next highest and time sensitive priority issue addressed was guidance on the Required Minimum Distribution (RMD) regulations to modify the minimum income threshold test to remove barriers to annuitization at later ages. The industry's third and fourth priorities, respectively, for the 2017-2018 plan year were guidance on combined annuity long-term care contracts and exchanges of annuities for long-term care insurance, and the use of foreign statement reserves for purposes of measuring qualified insurance income under IRC section 954(i).

In seeking public comments on the PGP in Notice 2017-28, Treasury and the IRS acknowledged the impact of the President's executive orders. At the IRS's specific request, the ACLI's PGP recommendations took into consideration Executive Orders 13771, 13777, and 13789, issued by President Trump. We observed that the executive orders offer a unique opportunity for modification, streamlining, and, in some cases, withdrawal of existing regulations to reduce regulatory costs and burdens for both taxpayers and the IRS, permitting reallocation of resources to appropriate guidance projects. To that end, we requested that the PGP item on regulations under sections 72 and 7702 defining cash surrender value be removed from the PGP since this is



not an area of material controversy, nor a particular burden, on tax administration. We further recommended that regulations relating to Foreign Account Tax Compliance Act (FATCA) as applied to life insurance products and companies, and generation skipping transfer tax (GSTT) withholding obligations on insurance companies, be withdrawn.

We also requested extensive modifications be made to the Life-Nonlife Consolidated Return Regulations to less restrictively implement the IRC provisions and, in certain cases, to eliminate regulatory restrictions that are not required by the IRC at all.

Our July 31 letter mirrored, in large part, the content of the recommendations in our PGP letter. The scope of issues raised was limited to existing proposed and final regulations since the executive orders exclusively addressed burdens created by existing regulations. In this letter, we identified modifications

to the Life-Nonlife Consolidated Return Regulations as the industry's highest priority, and recommended changes identical to those highlighted in our PGP letter. Our recommendations regarding other industry-specific issues were listed in order of priority as follows:

1. RMD guidance (modify);
2. Proposed regulations under 7702 defining cash surrender value (withdraw);
3. Application of FATCA to life insurance companies and products (withdraw);
4. Revise safe harbor explanations under §402 (f) for qualified plan administrators (modify);
5. Provide an exception from foreign bank account reporting (FBAR) for individuals who are signatories on life insurance companies' bank accounts (modify); and
6. GSTT withholding obligations on insurance companies should be eliminated (withdraw).

Finally, on July 7, the IRS released Notice 2017-38, in which it identified eight regulatory projects, including the controversial section 385 debt-equity regulations, as possibly imposing an undue burden on taxpayers or exceeding the IRS's authority. Treasury and IRS requested comments on whether the regulations described in this notice should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity. In mid-July, ACLI was asked to, and did, sign on to an Organization for International Investment (OFII) letter urging Treasury to act quickly to ease the burden of the section 385 regulations and ultimately completely rescind those rules.

On July 28, Treasury and IRS issued Notice 2017-36, which delays by 12 months the documentation requirements under Treasury Regulation Section 1.385-2 and now applies those

requirements to interests issued or deemed issued on or after Jan. 1, 2019. The notice acknowledges that the delay is an intermediate response born out of the review of the section 385 regulations. The notice also requests comments regarding whether the 12-month delay affords taxpayers adequate time to develop systems and processes to comply with the documentation regulations.

ACLI plans to advocate for the industry's guidance and regulatory priorities with the Trump Administration's officials in Treasury's Office of Tax Policy. ■

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ENDNOTES

- 1 For a full discussion of the President's executive orders and the IRS Priority Guidance Plan, please read, Mark S. Smith's *TAXING TIMES* Tidbit article in this issue entitled "Executive Orders on Regulatory Guidance Could Affect IRS Published Guidance."

T³: TAXING TIMES Tidbits

Negligence Penalty Imposed on Taxpayer Unable to Show Actual Consultation of Supporting Authorities

By Kenan Mullis

A recent ruling from a federal court in Minnesota presents the rare case in which the imposition of a penalty has warranted more attention than the holding on the underlying transaction—and for good reason. In *Wells Fargo & Co. v. United States*,¹ the United States District Court for the District of Minnesota held that the taxpayer's failure to prove *actual consultation* of legal authorities providing a basis for its tax return position justified the IRS's assessment of a 20 percent negligence penalty under I.R.C. § 6662(b)(1). The decision highlights the importance of creating and preserving contemporaneous documentation establishing the actuarial and legal foundations for return positions that may be challenged.

The facts of the case involve the taxpayer's participation in a structured trust advantaged repackaged securities (STARS) transaction.² In line with recent federal appeals court decisions on materially identical STARS transactions,³ the district court in *Wells Fargo* bifurcated the transaction's trust and loan components and held that the loan portion was not a sham and interest payments thereon were deductible. The trust structure had previously been determined to be a sham, and the taxpayer's claim of related foreign tax credits was disallowed.

Perhaps more significant, though, was the court's determination that the taxpayer was subject to I.R.C. § 6662(b)(1)'s negligence penalty on underpayments associated with the disallowed foreign tax credits. The regulations under I.R.C. § 6662 define "negligence" to include "failure[s] to make a reasonable attempt to comply with the provisions of the internal revenue laws." The definition excludes return positions that have a "reasonable basis," which means positions "reasonably based on one or more of the authorities set forth in



§ 1.6662-4(d)(3)(iii) . . .”⁴ In an effort to limit discovery with respect to the negligence penalty issue, the taxpayer stipulated, among other things, that it would not argue actual reliance on the authorities that form the basis of the reasonable basis defense. Thus, the question for the court became whether it was sufficient for the taxpayer to demonstrate its return position had a reasonable basis without proving that, in preparing the return, it had actually consulted the authorities establishing that reasonable basis.

The court examined the word “negligence” and explained that the term’s ordinary meaning indicates a focus on a taxpayer’s conduct and whether the taxpayer exercised due care. It acknowledged the taxpayer’s argument that the reasonable basis standard in Treas. Reg. § 1.6662-3(b)(1), which reads “[a] return position that has a reasonable basis as defined in [Treas. Reg. § 1.6662-3(b)(3)] is not attributable to negligence,” is, indeed, “cast in objective terms.” However, the court concluded that, when the regulation is read as a whole, there is ambiguity as to whether a taxpayer must have actually relied on the authorities referenced in Treas. Reg. § 1.6662-3(b)(3). In particular, the court focused on the regulation’s use of the term “return position.” A return position, according to the court, is essentially an opinion on the obligations the law imposes on a taxpayer, and the court could not envision how a taxpayer could “base” a return position on authorities without actually having consulted them. The court also noted that the substantial authority standard in Treas. Reg. § 1.6662-4(d)(2) is explicitly described as an objective standard, and the absence

of similar language in the reasonable basis standard indicates that the taxpayer's subjective analysis may be relevant. Having determined the regulation is ambiguous, the court concluded that Treasury's reasonable interpretation of its own regulation is controlling,⁵ and the reasonable basis defense includes a subjective element that requires the taxpayer to show actual reliance on the authorities forming the basis of that defense.

The lesson to take from the *Wells Fargo* case is the importance of contemporaneously documenting the basis for return positions. That documentation also should be retained through the end of the applicable limitations period. To be certain, the taxpayer in *Wells Fargo* created a unique handicap by waiving its right to demonstrate actual reliance on legal authorities. But, the holding makes clear that a post hoc determination that a return position had a reasonable basis is not sufficient, on its own, to avoid the imposition of the negligence penalty. A taxpayer also must be able to show that, at the time of taking the return position, it actually consulted the authorities that provide the reasonable basis for the position. This limits the universe of supporting authorities to those existing at the time of filing the return. Any rulings or guidance issued after the return position is taken, even those that support the taxpayer's position, would appear to be irrelevant to the reasonable basis analysis as applied in *Wells Fargo*. However, because the pertinent point in time is the taking of the return position rather than the execution of the transaction, authority issued after a transaction, but before that transaction is reduced to a position on a return, would appear to be germane to establishing a reasonable basis for the position.⁶

Treas. Reg. § 1.6662-4(d)(3)(iii) outlines the types of authority on which a return position may be based for purposes of the reasonable basis defense to the negligence penalty.⁷ While the regulation specifically excludes conclusions reached in treatises, legal opinions, or opinions by tax professionals, "[t]he authorities underlying such expressions of opinion" may provide a reasonable basis for a return position.⁸ Offering the contents of a legal or professional tax opinion as proof that those underlying authorities were actually consulted likely will jeopardize attorney-client or tax practitioner privilege.⁹ In many cases, a taxpayer might obtain an opinion for use as a shield in exactly this type of situation. However, as a practical matter, if waiving privilege is undesirable, maintaining an independent, contemporaneous file of the authorities that were consulted in forming the basis for a return position, even if they are the same authorities cited in an opinion, may offer a similar benefit without threatening privilege.

While *Wells Fargo* may be unusual for the fact that the taxpayer had waived the right to show actual reliance on the authorities underlying its return position, it is, nevertheless, a useful look into one court's interpretation of the negligence penalty.

The narrow reading of the reasonable basis defense in the case is striking, and this author is unaware of any other cases that explicitly interpret the defense in a similar manner. It is important to note, though, that this is a district court decision, and therefore, it is merely persuasive authority in most of the country. Regardless, *Wells Fargo* demonstrates the value of diligence in maintaining contemporaneous actuarial and legal records supporting return positions that could be challenged. As the axiom goes: an ounce of prevention is worth a pound of cure—or, rather, in the case of the negligence penalty, potentially worth a 20 percent penalty on the underpayment amount. ■

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ENDNOTES

- 1 No. 09-cv-2764 (D. Minn. May 24, 2017).
- 2 A STARS transaction is complex, and a discussion of the structure is beyond the scope of this article.
- 3 See *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016); *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015); *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).
- 4 Treas. Reg. § 1.6662-3(b)(1), (3). The reasonable basis standard is a significantly higher standard than not frivolous or not patently improper, and it is not satisfied by a claim that is merely colorable. However, the standard is less demanding than the substantial authority standard. Treas. Reg. § 1.6662-3(b)(3).
- 5 The court determined Treasury was entitled to Auer deference, which applies to an agency's reasonable interpretation of its own ambiguous regulation unless that interpretation is plainly erroneous or inconsistent with the regulation. *Auer v. Robbins*, 519 U.S. 452 (1997).
- 6 Cf. Treas. Reg. § 1.6662-4(d)(3)(iv)(C) ("There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.").
- 7 See Treas. Reg. § 1.6662-3(b)(3).
- 8 Treas. Reg. § 1.6662-4(d)(3)(iii). Treas. Reg. § 1.6662-4(d) deals with the substantial authority defense to the I.R.C. § 6662(b)(2) substantial understatement penalty, and subparagraph (d)(3)(iii) explains that the authorities underlying a legal or tax professional opinion "may give rise to substantial authority for the tax treatment of an item." *Id.* As mentioned in a previous footnote, the reasonable basis standard is lower than the substantial authority standard, which requires a greater than 50 percent likelihood of a position being upheld. See Treas. Reg. §§ 1.6662-3(b)(3), -4(d)(2).
- 9 See, e.g., *Salem Fin., Inc. v. United States*, 102 Fed. Cl. 793 (Jan. 18, 2012) (tax practitioner privilege was waived when the taxpayer relied on its accountant's advice as a defense against penalties). With respect to tax advice, the common law protections of confidentiality afforded to communications between a taxpayer and an attorney also apply to communications between a taxpayer and any federally authorized tax practitioner. I.R.C. § 7525(a)(1). Federally authorized tax practitioners include attorneys, certified public accountants, enrolled agents, and enrolled actuaries. See I.R.C. § 7525(a)(3)(A); 31 U.S.C. § 330; S. Rep. No. 105-174, at 70-71 (1998). Note, however, that this "tax practitioner privilege" may only be asserted in noncriminal tax matters before the IRS and in noncriminal proceedings in federal court brought by or against the United States. I.R.C. § 7525(a)(2).

Executive Orders on Regulatory Guidance Could Affect IRS Published Guidance

By Mark S. Smith

The Internal Revenue Service (IRS) and Treasury Department publish a Priority Guidance Plan (PGP) each year to identify and prioritize tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published guidance. The annual PGP focuses resources on issues that are most important to taxpayers and tax administration. Recent PGP's have prioritized guidance on a number of insurance issues including principle-based reserves, private annuities, the definition of cash value, annuity contracts with long-term care riders, and captive insurance.

This year, as in the past, the IRS published a notice inviting recommendations for items that should be included in the 2017-2018 PGP. Unlike prior years' notices, however, Notice 2017-28, 2017-19 I.R.B. 1235 (May 8, 2017), also references new executive orders that were issued in the early days of the Trump Administration and could affect the decision to include (or exclude) certain items from the 2017-2018 Priority Guidance Plan. Those executive orders are:

E.O. 13771 (Jan. 30, 2017)
Reducing Regulation and Controlling Regulatory Costs

E.O. 13777 (Feb. 24, 2017)
Enforcing the Regulatory Reform Agenda

The first—E.O. 13771—is by far the most important generally, though likely not for tax. It requires that the total incremental cost of all new regulations to be finalized in 2017 be no more than zero. It also requires that for every one new regulation that is issued, at least two prior regulations be identified for elimination. The exact application of this E.O. to tax guidance is not fully known. Tax guidance, in particular, poses unique issues compared to regulations of other agencies due to unique issues in measuring cost, the variety of guidance items that the IRS publishes, and the fact that in many cases tax guidance



is welcomed by taxpayers because it reduces uncertainty and hence controversy upon examination. Even if it is determined that E.O. 13771 does not apply to most tax guidance, it nevertheless operates as a limitation where it does apply.

The second E.O. referenced in Notice 2017-28—E.O. 13777—directs agencies to undertake certain activities to reduce the burdens agencies place on the American people. Much of this order is administrative in nature. For example, it directs each agency to establish a Regulatory Reform Office and a Regulatory Reform Task Force, whose task it is to ensure agency compliance with a variety of executive orders and other guidance from the administration aimed at limiting regulatory burden. In particular, E.O. 13777 requires each Regulatory Reform Task Force to identify regulations that are outdated, unnecessary, or ineffective, or that impose costs that exceed benefits. At a minimum, these executive orders will require the IRS to give additional thought to each item that is selected for inclusion in the PGP.

In addition to the executive orders cited in Notice 2017-28, E.O. 13789 (April 21, 2017), “Identifying and Reducing Tax Regulatory Burdens,” directs the Treasury Secretary to identify in an interim report to the president all significant regulations issued by the Treasury Department since 2016 that either (i) impose an undue financial burden; (ii) add undue complexity to the tax laws; or (iii) exceed the statutory authority of the IRS. On July 7, the IRS released Notice 2017-38, 2017-30 I.R.B. 147 (July 24, 2017), describing the Treasury Department’s activities under the executive order and identifying eight regulations as significant and as meeting at least one of the three enumerated criteria. The notice requests public comment on whether the regulations should be rescinded or modified and, if modified, how. The eight identified regulations include regulations under section 385 of the Internal Revenue Code, addressing whether certain instruments should be treated as debt or equity. Those regulations drew significant criticism, including from the insurance industry, when they were originally proposed. Although many of the industry’s concerns were addressed, the regulations still pose a challenge for insurers in some situations.¹

Like other industries, the insurance industry has grown accustomed to a PGP that contains a handful of familiar publication

projects that the IRS will prioritize in the coming year. Regardless of whether the 2017-2018 PGP looks different from prior years’ PGPs, it is certain that whatever items end up in the PGP will have undergone closer scrutiny and overcome additional hurdles as a result of these executive orders and the regulatory agenda of the new administration. ■

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ENDNOTES

- 1 In addition to regulations under section 385, Notice 2017-38 identifies proposed regulations on the definition of a political subdivision, temporary regulations on the transfer of property to regulated investment companies and REITs, regulations on summons interview, proposed regulations on restrictions on liquidation of an interest for estate and gift taxes, temporary regulations on recourse partnership liabilities, regulations on certain income and currency gain or loss, and regulations on the treatment of transfers of property to foreign corporations.



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Synopsis of Issue Brief: Claim Reserve Assumption Basis for Long-Term Disability Policies: Use of Date of Incurral versus Date of Issue

By the Tax Work Group of the American Academy of Actuaries,
Barbara Gold, Chairperson

During the past few years, the Tax Work Group of the American Academy of Actuaries (the Academy) has addressed the question of when interest rate assumptions might be determined in the calculation of tax reserves for Long-Term Disability (LTD) claims incurred. The result

of this analysis is an issue brief, recently published by the Academy, entitled “Claim Reserve Assumption Basis for Long-Term Disability Policies: Use of Date of Incurral versus Date of Issue.”

The issue brief describes the products and reserves under consideration, explores the historical context of the statutory and tax rules, and analyzes the actuarial considerations relevant to the choice of an appropriate interest rate. The issue brief discusses the potential rationale for determining the incurred claim reserve discount rate either as of the date of claim incurral or as of the date the policy was issued. In the issue brief, the Tax Work Group concludes that setting the discount rate using the incurral date, rather than the issue date, is an actuarially sound basis for the valuation of group and individual LTD tax claim reserves, and it is also consistent with statutory accounting rules. The issue brief may be accessed at www.actuary.org/files/publications/Acad_taxwg_brief_LTD_072817.pdf. ■

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