

# Federal Income Tax Update

Boston/Hartford Actuarial Clubs

Meeting

November 18, 2010

**LECG**

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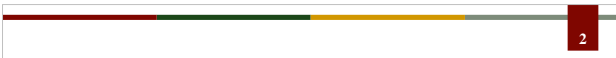
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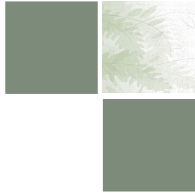
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## Panelists

- Brian G. King, LECG
- Michael J. LeBoeuf, LECG



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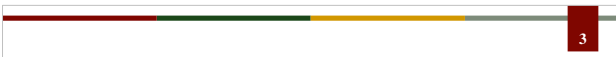
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## Agenda – Product Issues

- Calculations after age 100
  - Notice 2009-47 and Rev. Proc. 2010-28
- Definition of cash value/ROP benefits
- Notice 2006-95 and 2001 CSO transition
- Contingent and deferred payout annuities

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### Agenda – Company Issues

- Actuarial Guideline 43 (VACARVM)
  - Notice 2010-29
- Retroactivity of actuarial guidelines
- Deficiency reserves and the statutory reserve “cap”
- Separate account DRD

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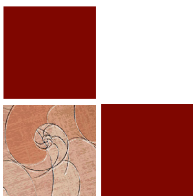
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### Revenue Procedure 2010-28: Post-100 Calculations



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### Section 7702/7702A Calculations Post-100

- Limiting age of 121 under 2001 CSO tables
  - Section 7702(e)(1)(B) requires calculations to assume maturity between ages 95 and 100; section 7702A follows this rule
  - 2001 Maturity Age Task Force of SOA Taxation Section published report on section 7702 issues in *Taxing Times* in May 2006
- IRS Notice 2009-47 published in June 2009
- Rev. Proc. 2010-28 published August 2010

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**Post-100 Calculations – Notice 2009-47**

- Notice 2009-47 proposed section 7702/7702A calculation “safe harbor ... drawn from [Task Force] proposal, with modifications.”
  - Safe harbor consists of all “Age 100 testing Methodologies” in Notice § 3.02
  - Notice § 3.02(i): “... a contract that remains in force would additionally be required to provide at all times a death benefit equal to or greater than 105 percent of the cash value.”

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**Rev. Proc. 2010-28, 2010-34 I.R.B. 270**

- Replaces Notice 2009-47 which is obsolete
  - Effective August 23, 2010
- Generally accepts Age 100 methodologies from Notice 2009-47
  - Eliminates the 105% requirement
  - No adverse inference on qualification or MEC status if safe harbors are not met
- Does not address “additional issues” on which comments were requested in Notice 2009-47

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**Rev. Proc. 2010-28 § 3.02 Safe Harbor Rules**

- (a) All section 7702/7702A calculations assume age 100 maturity
- (b) NSP (CVAT) and “necessary premium” calculations assume endowment at age 100
- (c) GLP is calculated assuming premiums through age 99
- (d) GLPs accrue through date between ages 95 and 99, after which limit applies indefinitely

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### Rev. Proc. 2010-28 § 3.02 Safe Harbor Rules

- (e) 7-pay premiums computed using remaining durations to age 100
- (f) If 7-pay premiums accrue over fewer than 7 years under (e), accrual ends at age 100, after which limit applies indefinitely
- (g) Reduction-in-benefit rules apply regardless of attaining age 100
- (h) Benefit change after age 100 is not material change or adjustment event

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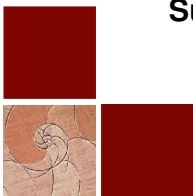
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### Return of Premium/Cash Value Enhancements: Treatment under Section 7702 Definition of “Cash Surrender Value”



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### Return of Premium/Cash Value Enhancements – In General

- Focus of discussion: enhancement to cash value payable on full contract surrender guaranteeing return of premium, credit on expenses, etc.
- Available on individual and corporate owned contracts
- Provided by insurer’s guarantee or via third party “wrap” provider’s payment to insurer
- Available on CVAT and GPT contracts

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### Return of Premium/Cash Value Enhancements – Section 7702 Treatment

- Question – How to treat return of premium/cash value enhancement under section 7702?
- 4 private letter rulings address the issue:
  - PLR 200521009 (waiver request)
  - PLR 200528018 (waiver request)
  - PLR 200745006
  - PLR 200901028 (waiver request)

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### Return of Premium/Cash Value Enhancement Features

- No borrowing permitted against enhancement in the 4 private letter rulings
- All 4 rulings held: enhancement is included in the contract's section 7702 "cash surrender value"
- IRS granted all 3 waiver requests – insurers were required to remediate failed contracts

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### Return of Premium/Cash Value Enhancement Features

- Prop. Treas. Reg. sec. 1.7702-2: section 7702 "cash surrender value" is greater of maximum amount payable under contract (without regard to any surrender charge or policy loan), or maximum amount policyholder can borrow
- Compare with 1984 legislative history
- Notice 93-37 – Prop. Reg. not effective, but ....
- Will Prop. Reg. be withdrawn/reissued?

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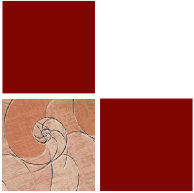
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## Transition to 2001 CSO Mortality: Notice 2006-95



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### Notice 2006-95

- Notice 88-128 interim rules still in effect
- 1980 CSO safe harbor:
  - 100% of 1980 CSO
  - Permitted by state at issue date
  - Issued before January 1, 2009
- 2001 CSO safe harbor:
  - 100% of 2001 CSO, subject to contract guarantees
  - Permitted by state at issue before January 1, 2009
  - Issued after December 31, 2008

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### Notice 2006-95 (cont'd)

- Issue date follows section 7702 original issue date standards (§ 5.01)
- § 5.02 conditions under which change to 2001 CSO is not required:
  - Change is made pursuant to contract terms,
  - State does not require use of 2001 CSO, and
  - Same policy form is used

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### Notice 2006-95 (cont'd)

- § 5.03 examples:
  - Add or drop rider or QAB
  - Increase or decrease in death benefit (whether or not underwritten) or change in death benefit option
  - Reinstatement within 90 days

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### Material Changes and Adjustments

- Notice 2006-95 and grandfathering
  - Notice utilized section 7702 effective date rules
- CCA 200805022
  - Contracts issued before but changed after January 1985 general effective date of section 7702 (DEFRA) and October 1988 effective date of reasonable mortality rules (TAMRA)
  - CCA addressed contracts' loss of grandfathering

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### CCA 200805022

- Original ruling request withdrawn by taxpayer
- Pre-DEFRA and pre-TAMRA grandfather treatment would be lost if:
  - Change from an "option 2" increasing death benefit to an "option 1" level death benefit
  - Add QAB rider
- Adjustment vs. "new contract" treatment
- Relationship of CCA to Notice 2006-95

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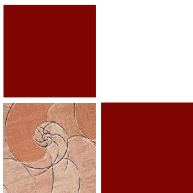
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## Contingent and Deferred Payout (Longevity) Annuities



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## What is a Contingent Payment Annuity?

- Unbundled annuity contract
  - Concept bifurcates investment and insurance elements of traditional deferred annuity with lifetime guaranteed minimum withdrawal benefit (GMWB)
  - Investment element (e.g., mutual fund) stays with CDA policyholder
  - Insurance element (the CDA) relates specifically to lifetime GMWB
  - CDA pays benefit only if underlying account value reduces to \$0

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## Akin to Living Benefit Riders

- CDA operates akin to GMWB or guaranteed minimum income benefit (GMIB) under deferred annuity
  - Under both products, policyholder allowed to withdraw set amount or percentage from underlying assets, which must be invested pursuant to approved model
- Principal difference: investment assets are held outside CDA, whereas assets of deferred annuity with GMWB/IB are held by insurer as part of annuity

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### IRS Rulings

- In 2009, IRS issued several private letter rulings regarding CDAs, holding *on particular facts*:
  - CDAs were annuities for federal tax purposes
  - Existence of CDA did not prevent accountholder from deducting otherwise allowable losses on investment account assets
  - CDA would not affect "holding period" of investment account assets nor give rise to a "straddle" (relating to qualified dividend rules and nature of assets' gains and losses)

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### PLR 200949036

- PLR addresses tax issues for insurer
- PLR concludes CDA is annuity contract
  - Implications of conclusion for insurer
    - Clarifies reserve deduction under section 807
    - Clarifies withholding and reporting obligations
  - Implications of conclusion for policyholder
    - Annuity payments are eligible for "exclusion ratio" treatment

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### PLRs 200949007 and 201001016

- PLRs clarify taxation of investment account for policyholder
  - Policyholder retains ability to deduct losses incurred on investment account assets
  - Policyholder can recognize qualified dividend income from investment account
  - CDA does not form part of straddle with investment account assets

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### Longevity Annuity

- Longevity annuity is another “new” product that addresses increasing concern with outliving one’s assets – if annuitant is alive at set age, payments are made
- Like CDA, longevity annuity has no cash value during deferral stage
- Unlike CDA, longevity annuity makes payments regardless of performance of other investments
- Payment trigger is age alone

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### IRS PLR on Longevity Annuity

- IRS issued one PLR on longevity annuity (in 2009)
- IRS reviewed history of annuity products and concluded that specific longevity annuity under review was annuity for federal tax purposes
- In particular, absence of cash surrender value did not negatively affect tax treatment of product

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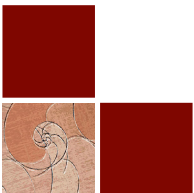
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### Actuarial Guideline 43



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### Actuarial Guideline 43

- On March 25, 2010 the Treasury and IRS issued Notice 2010-29
- This new notice follows-up Notice 2008-18, in which the Treasury and IRS provided initial views and questions related to adoption of AG 43 and PBR generally
- Notice 2010-29 provides “interim” guidance on certain company tax issues under Actuarial Guideline XLIII (AG 43) (VACARVM)

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### AG 43 Statutory Reserving

- AG 43 (VACARVM) is effective for variable annuity statutory reserves beginning on December 31, 2009
  - Includes all contracts issued from 1981 forward
- Replaces AG 34 (GMDB) and AG 39 (VAGLB) reserves
- Provides a 3-year grade in, if the AG 43 reserves are greater than the AG 34/39 reserves, as a “permitted practice” with the permission of the state of domicile

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### AG 43 Requirements

- AG 43 follows the overall pattern of principle-based reserves:
  - A deterministic component assuming a single economic scenario
  - A stochastically derived component using multiple economic scenarios
- Reserve = Standard Scenario Amount floor (SSA) plus the Stochastic Excess (the excess of the CTE Amount over the SSA)

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### IRS Notice 2010-29

- Provides “interim” guidance on VACARVM/AG 43.
  - Standard Scenario Amount included in life insurance reserves, Federally Prescribed Reserves and Statutory Reserves Cap
- No discussion of Stochastic CTE Amount except not included in Federally Prescribed Reserves
- AG 43 not retroactive for contracts issued prior to December 31, 2009
  - 10-year spread rule of Section 807(f) applies to tax reserve changes resulting from AG 43 statutory reserves capping
- No inference on other issues

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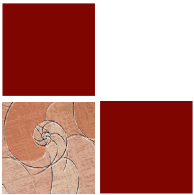
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### Retroactivity of Actuarial Guidelines




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### Retroactivity

- Question – Can Actuarial Guidelines and other authoritative actuarial guidance apply to insurance contracts previously issued and in force?
- General Rules
  - Section 807(d)(2) provides in part that the reserve for any contract must be determined using the tax reserve method applicable to that type of contract
  - Section 807(d)(3)(B) defines the CRVM and CARVM valuation methods as those “in effect on the date of the issuance of the contract”
  - Section 807(d)(4)(A)&(B) provide the AFIR and PSAIR are determined for the “calendar year in which the contract is issued”
  - Section 807(d)(5)(A) provides the prevailing commissioners’ standard tables are those permitted in computing reserves under the laws of at least 26 States when the contract is issued

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### IRS Guidance

- TAM 200108002
  - Use of graded interest rate method for structured settlements was a permissible interpretation of CARVM prior to adoption of AG 9B
- Revenue Ruling 2002-6
  - Taxpayer issued annuity contracts in 1999 and 2000, but did not apply certain factors required in AG 33; in 2001, Taxpayer changed its reserving method to comply with AG 33
  - IRS held the changes in 2001 were a change in basis under Section 807(f) subject to a 10-year spread
- TAM 200328006
  - IRS held retroactive application of AG 33 to compute tax reserves on contracts issued prior to Dec. 31, 1995, was impermissible under Section 807(d)(2)
- TAM 200448046
  - Connecticut reserve method could not be used for guaranteed minimum death benefits under variable annuities prior to the adoption of AG 34 because it was contrary to "the prevailing state practice" at the time the contracts were issued
- Notice 2010-29
  - For variable annuities issued prior to Dec. 31, 2009, the tax reserves method is determined under relevant guidance in effect before adoption of AG 43

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### Court Cases

- American Financial
  - Held AG 33 has retroactive effect – deference to NAIC’s interpretation of AG 33 as clarification of existing CARVM
  - Notice of appeal filed
- CIGNA
  - IRS contending that AG 34 is not retroactive

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### Actuarial Guideline 39

- Applies to reserves for VAGLB under VA contracts – sunset on Dec. 31, 2009
- Reserves equal sum of (1) and (2) where:
  - (1) equals greater of cash value or CARVM reserves ignoring future revenues and benefits from VAGLB; and
  - (2) equals sum of explicit or implicit VAGLB charges from issue date, plus aggregate asset adequacy reserve, if necessary

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### AG 39 Charge Accumulation Reserve

- Is reserve a CARVM reserve for purposes of Section 807(d)?
- Did AG 39 sunset for tax purposes?
- If so, how are CARVM tax reserves computed for pre-Dec. 31, 2009 contracts?

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### Actuarial Guideline 34

- Applies to reserves for GMDB under VA contracts
- Continues to apply for tax reserves for pre-Dec. 31, 2009 contracts
- IRS auditors raising issues for income projection rate for tax reserves
  - Use of AFIR, rather than statutory valuation rate, less asset based charges
  - CIGNA – Account value drop and recovery assumption

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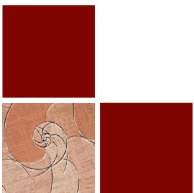
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### Deficiency Reserves and the Statutory “Cap”



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## Statutory Reserves Cap

- Section 807(d)(1) provides that the deductible reserve is the greater of the federally prescribed reserve and the net surrender value but not greater than the statutory reserve
- Section 807(d)(6) – statutory reserves defined as aggregate amount set forth in the annual statement “with respect to” tax reserves
- Deficiency reserves
  - 1984/1986 legislative history – deficiency reserves are in statutory reserves cap
  - IRM says deficiency reserves are included
  - 1993 FSA – concluded deficiency reserves not included
  - Issue generally conceded at IRS Appeals
  - Issue on the IRS Business Plan

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## Statutory Reserves Cap (cont'd)

- Rev. Rul. 2008-37
  - If a life insurance company does business in several states with different minimum reserve requirements, the amount of the company's statutory reserves for purposes of Section 807(d) is the highest aggregate reserve amount set forth on an annual statement pursuant to the minimum reserving requirements of any state in which the company does business
- Notice 2010-29
  - For statutory reserves cap, Standard Scenario Amount in AG 43 is included in statutory reserves
  - No comment on CTE amount
- AG 39 – Is asset adequacy reserve included in statutory reserves cap? If so, how is it allocated to individual contracts?

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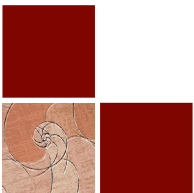
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## Separate Account DRD



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### Separate Account DRD

- Under Sections 805(a)(4) and 812, the DRD is disallowed to the extent dividend income is credited to policyholders
- The percentage disallowance is determined by prorating the company's total net investment income between the amounts credited to policyholders ("policy interest") and the amount retained as the company's share
- Required interest is the largest item of policy interest and is the interest credited to tax reserves for the taxable year

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### Key Reserves Concepts for Variable Contracts

- Under Section 807(d), life insurance reserves for tax purposes are computed following NAIC guidance, but by substituting prescribed interest rates and mortality tables
- Under Section 817, separate accounting is required for non-guaranteed benefits in variable contracts, including tax reserves
- Under Section 812, required interest generally is determined by the interest rate specified for tax reserves under Section 807(d) unless that rate is not "used" in which case "another appropriate rate" applies

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### Rev. Rul. 2007-54

- Issue 1 –
  - Concluded that there is only one tax reserve for a variable contract; separate accounting for segregated asset account has no effect on how tax reserves are calculated
- Issue 2 –
  - Concluded that if the single tax reserve for the contract uses the interest rate under Section 807(d)(2), that rate must be used to compute required interest for purposes of proration

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### Rev. Rul. 2007-61

- Suspended Rev. Rul. 2007-54
- Announced Treasury and IRS will address the DRD issues in regulations
- Until regulations are issued, the DRD issues should be analyzed as though Rev. Rul. 2007-54 had not been issued

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### Current Status of DRD Issue

- LMSB – IDD issued May 20, 2010
  - Adopts position in TAMs 200038008 and 200339049
  - Directs IRS agents to raise questions where taxpayer changes method of DRD calculation and to verify consistency with state law treatment of separate account
- Appeals Division – follows TAMs
- IRS Business Plan – proposed regulations in process
- Administration's 2011 Budget Proposal – proposed legislative amendment to limit DRD for variable contracts

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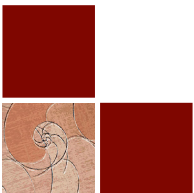
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### QUESTIONS?



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