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# Taxing Times

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# From the Chair Welcome to the Taxation Section Council

By Tony R. Litterer

The dawn of a new era is upon us. By the time this message is published, many individuals and companies will have filed their 2018 tax returns. How has the Tax Cuts and Jobs Act (TCJA) impacted you? For the Taxation Section, 2018 was a year to be remembered.

As their three-year term comes to a close, the departing members of the Taxation Section should be proud of their contributions to the section and the industry. Housseine Essaheb, Jeff Harper and Michelle Cramer completed their third year on the council, and what a year it was. The signing of TCJA on Dec. 22, 2017, by President Trump created a need for information. The section, under Mr. Essaheb's leadership, met the need through a host of different in-person seminars, webinars and our *TAXING TIMES* newsletter. Each departing council member shared in these responsibilities in one way or another.

In addition, Mark Smith served with distinction for the past three years as the affiliate council member representing the legal community. In this role, Mr. Smith shared his knowledge and expertise of various tax topics, generally from a legal perspective. As an affiliate council member, he held the only voting position on the council available to someone other than an actuary. Even though Mr. Smith was willing to continue on as the affiliate council member for yet another term, the Society of Actuaries (SOA) bylaws prohibit successive periods of such length.

A door may have closed, and, as the saying goes, a window was opened.

The chair is pleased to share that Dave Noga and Sandhya Ramakrishnan were nominated and have accepted their positions on the council. Both individuals bring a variety of knowledge to the section, ranging from valuation to product development. We also accepted the resignation of Siksha Dhar and Vincent Zink from the section council, and we thank them for their service. For the remainder of the 2019 term Jeffrey Stabach and James "Jim" Weaver have volunteered for section council.



With all these changes in section leadership, the section will have five council positions available beginning next October. The section council terms will vary between 1 and 3 years. We welcome new members to the council, as each brings a fresh perspective and new voice to our section. It is a great opportunity for any SOA member to be a part of our section, as volunteerism is at the core of the Taxation Section.

It is a pleasure to announce Jean Baxley as the new affiliate council member of the section. Ms. Baxley, as many of you may know, was extremely busy during 2018. She spoke at several sessions and contributed to *TAXING TIMES* during the year, helping to bring awareness of the changes created by TCJA.

Last, a special recognition goes to John Adney. Mr. Adney contributed to the section for many years. He authored numerous articles for *TAXING TIMES*, spoke at industry conferences and served on the *TAXING TIMES* editorial board. After all these years, he says retirement from the editorial board beckons. Going forward, the section hopes Mr. Adney will continue to contribute informative articles for the section. It is an honor to salute Mr. Adney as editor emeritus as we move forward.

In closing, if you are reading this publication and have a desire to contribute, please reach out to one of the section council members or check the SOA's Volunteer Opportunities website at [engage.soa.org](http://engage.soa.org). ■

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# In the Beginning . . . A Column Devoted to Tax Basics How Does ERISA Apply to Annuities?

By Michael L. Hadley

In the October 2018 issue of *TAXING TIMES*, my “In the Beginning” article discussed the basic taxation rules for “qualified” annuities. “Qualified” is the term used for annuities that are issued in connection with a qualified Code section 401(a) pension or profit-sharing plan, section 403(b) plan, section 457(b) plan, or individual retirement account or annuity (IRA), all of which receive special tax treatment under the Internal Revenue Code. I pointed out that there was not space to address the Employee Retirement Income Security Act of 1974 (ERISA), which is the key law governing the design and operation of employer-based retirement plans. I foolishly suggested a future article could discuss it, and the editors have taken me up on that. But fear not—while ERISA is sometimes viewed as impenetrable and hopelessly complex, it is possible to understand the basics, in particular the ways that ERISA impacts annuities sold to employer-based retirement and other benefit plans.

To regulate employer-based retirement plans, Congress has settled on a “carrot” and “stick” approach, and a well-administered annuity issued in connection with an employer-based plan should be cognizant of both. The “carrot” is very favorable tax deferral of contributions and earnings, but with myriad complex rules under the Code. The “stick” is ERISA. ERISA imposes reporting, plan design, fiduciary and other requirements on certain employer-based retirement plans, which from now on I’m going to refer to as “ERISA-governed plans.” Most of the obligations under ERISA fall on the employer or other fiduciary administering the plan, although some obligations are imposed on issuers of annuities sold to ERISA-governed plans, such as certain disclosure obligations.

When I speak with life insurance companies that are currently issuing or planning to issue annuities to ERISA-governed plans,

I typically go through a series of questions that I will use as our entry into the basics of ERISA.

- Is the annuity being issued in connection with an ERISA-governed plan?
- What will be treated as plan assets?
- Who are the fiduciaries of the plan, and more to the point, is either the insurance company or the distributor (broker or agent) a fiduciary under ERISA?
- What disclosures will be generated because this plan has purchased this annuity?

At the end of the article, I will also say a brief word about Title IV of ERISA, which governs the termination of an ERISA-governed defined benefit plans and thus is relevant to what the industry calls “terminal funding” contracts, *i.e.*, annuity contracts issued to settle the obligations of a terminating defined benefit plan. I will also mention when it makes sense to get an ERISA expert involved.

So, let’s say you’ve concluded that the annuity is issued in connection with an ERISA-governed plan. Don’t panic—everything will be OK.

One last preliminary point. You have surely heard something about the Department of Labor’s (DOL) ill-fated “Fiduciary Rule,” which was struck down by a court in March 2018. This article is not about that regulation, although I will mention in a couple places how it would have fit into the overall ERISA regulatory structure. OK, let’s get started.

## IS THE ANNUITY BEING ISSUED IN CONNECTION WITH AN ERISA-GOVERNED PLAN?

The terms “qualified” annuity and “ERISA-governed” plan do not mean the same thing. Qualified annuities, as the term is used in our industry, includes arrangements not governed by ERISA, such as IRAs.<sup>1</sup> And ERISA-governed plans can hold contracts that do not have the hallmarks of a qualified annuity and, of course, many other kinds of assets.

ERISA applies to a plan that is established or maintained by an employer and that either provides retirement income or results in the deferral of income for employees to periods extending

beyond termination of employment. This is called a “pension plan” in ERISA, and it includes both defined benefit plans and defined contribution plans. However, since in common parlance the term “pension plan” is often used to refer only to defined benefit plans that provide a “pension,” I’m going to use the term “retirement plan” to refer to both defined benefit plans and defined contribution plans such as 401(k) and 403(b) plans. ERISA also applies to what are called “welfare” plans, that is, plans established or maintained by an employer that provide health, disability or death benefits; but in this article, we will focus on retirement plans.

In other words, ERISA applies to a plan that an employer establishes to provide retirement or deferred income to its employees. But there are, of course, some very important exceptions, and sometimes a life insurance company will focus its annuity sales solely on plans exempt from ERISA. But each of the exceptions come with traps that should be kept in mind.

- **Governmental plans and church plans.** When ERISA was passed in 1974, there was a concern about imposing rules on plans established and maintained by state and local governmental employers (because of federalism concerns) and by churches (because of First Amendment concerns).<sup>2</sup> Instead, these plans are subject to state law and, of course, must also meet the requirements of the Internal Revenue Code to receive favorable tax treatment. The trap here is that many states have enacted “mini-ERISA” laws that apply similar rules to the plans offered to state and local government employees.<sup>3</sup> When dealing with a state or local government plan, do not assume there is a free pass from ERISA-like rules.
- **Plans covering no employees.** To be an ERISA-governed plan, the arrangement must cover at least one employee. Thus, a plan covering only a business owner (and spouse)—which you will sometimes see referred to as a “solo 401(k) plan,” “Keogh plan” or “H.R. 10 plan”—is not subject to ERISA.<sup>4</sup> But beware of a trap—if you issue a contract to a plan not currently subject to ERISA because the business has no employees yet, do not assume the plan will forever be exempt from ERISA.
- **Plans with minimal employer involvement.** Just because a retirement savings program is funded through payroll contributions does not mean it is a plan “established or maintained” by an employer. DOL rules include exemptions from ERISA for voluntary savings arrangements where no employer contributions are involved and the involvement of the employer is minimal.<sup>5</sup> The most commonly encountered of these arrangements are non-ERISA 403(b) plans of tax-exempt employers, which involve only payroll contributions.

But here the trap is that the employer must be extremely careful to avoid any more than minimal involvement, which has become increasingly difficult since the Internal Revenue Service (IRS) rewrote the section 403(b) regulations in 2007.

- **Deferred compensation plans for executives.** Deferred compensation plans that cover only a select group of highly compensated and management employees—which are given the fairly old-fashioned name “top hat plans”<sup>6</sup>—are exempt from the vast majority of ERISA’s requirements.<sup>7</sup> The thinking behind this exemption is that ERISA is designed to protect employees and ensure promised benefits are paid, but the most senior executives in a company can adequately protect their own interests. The trap here is that there are some ERISA requirements that apply (*i.e.*, a filing is due with DOL, and a few ERISA requirements, like claims procedures, must be written into the plan documents).

#### WHAT WILL BE TREATED AS PLAN ASSETS?

So, let’s say you’ve concluded that the annuity is issued in connection with an ERISA-governed plan. Don’t panic—everything will be OK. The next step is to determine which assets associated with the plan are considered “plan assets.” The reason this is the next step, and not the disclosure or fiduciary rules, is because many of ERISA’s requirements are targeted to the plan’s assets. Therefore, figuring out what the plan “owns” is critical to understanding where we must be careful.



ERISA requires that all of the plan's assets be held either in a trust or in insurance contracts. Thus, the plan's assets will include the assets held in the trust and the interests represented by the insurance contract. But DOL has also issued what are called the "pass-through" rules, which look through certain investment arrangements and treat the underlying assets of the investment as also constituting plan assets. For example, subject to a number of exceptions, if a plan's trust invests in a limited partnership or unregistered collective investment trust, the plan's assets include not only the shares of the limited partnership or unregistered collective trust but also those investment vehicles' *underlying assets*, which means that the investment managers of those investments are ERISA fiduciaries.<sup>8</sup> This does not apply with all investments. For example, if a plan purchases shares of a registered mutual fund, or the shares of an operating company (like Facebook or IBM), the plan is deemed to own only those shares and not underlying assets of the company.

Applied to annuity contracts, the "pass-through" rules (a) do not apply to fixed annuities that are supported by the insurance company's general account, but (b) do apply to variable annuities that are supported by a separate account. (This is true whether the contract is a group or individual annuity.) There are some nuances and caveats to this general rule, and it has been the subject of litigation, but for a basic summary, that's close enough. ERISA uses the term "guaranteed benefit policy" to refer to fixed annuities that are exempt from the "pass-through" rule.<sup>9</sup>

In other words, when a plan pays premiums to a variable annuity, the assets in the insurance company's separate account are treated as plan assets and ERISA's fiduciary rules attach. Again, don't panic; variable annuities can be structured easily to ensure compliance with ERISA.

#### WHO ARE THE PLAN FIDUCIARIES?

Who are the fiduciaries of the plan, and more to the point, is either the insurance company or the distributor (broker or agent) a fiduciary under ERISA? Every ERISA-governed plan has one or more fiduciaries. In fact, ERISA requires that every plan must have a governing plan document and that the document must name one or more fiduciaries who are, big surprise, called the plan's "named fiduciaries."<sup>10</sup> But even if a person is not named in the plan's governing document, fiduciary status can still apply if the person exercises a function that is fiduciary in nature.

There are three functions that trigger fiduciary status:

- **Investment discretion.** A person is a fiduciary to the extent that person exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or



disposition of its plan assets. In English, this means anyone who can or does make investment decisions, including determining which investments will be available on the 401(k) plan's menu, is a fiduciary.<sup>11</sup>

- **Plan administration.** A person is a fiduciary to the extent that person has any discretionary authority or discretionary responsibility for the administration of the plan. For this purpose, "administration" includes functions like hiring and monitoring service providers to the plan, making decisions about eligibility for contributions and benefits, and keeping the plan tax-compliant.
- **Investment advice.** A person is a fiduciary to the extent that person renders investment advice for a fee or other compensation, direct or indirect, or has any authority or responsibility to do so. The DOL's Fiduciary Rule that caused such a brouhaha during the past five years or so was focused solely on what constitutes investment advice and did not involve the two other fiduciary functions.

With most plans, the employer names itself to take on the first two functions (investment decisions and plan administration). The employer typically designates an internal committee that meets regularly to make these decisions. The committee may hire other fiduciaries, such as investment managers and investment advisers to assist. But the plan's primary service provider (*e.g.*, the "recordkeeper" or third-party administrator) generally does not act as a fiduciary.

Here's the punchline to why this is so important. The key thrust of ERISA is to regulate, and it's fair to say *heavily* regulate, the

conduct of fiduciaries. They must live by what I think of as the five commandments of ERISA:<sup>12</sup>

1. **Thou shalt be loyal.** ERISA requires that plan fiduciaries act solely in the interests of plan participants and beneficiaries and allow plan assets to be used solely to benefit plan participants and pay reasonable expenses.
2. **Thou shalt be prudent.** ERISA requires fiduciaries to abide by the “prudent expert” standard in all decision-making—that is, to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
3. **Thou shalt diversify.** ERISA fiduciaries must diversify plan investments to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
4. **Thou shalt follow the plan.** A fiduciary must follow the plan documents that govern the plan unless doing so would otherwise violate ERISA.
5. **Thou shalt avoid prohibited transactions.** ERISA contains a list of transactions that the fiduciary may not allow to occur, including avoiding the fiduciary engaging in any conflicts of interest, unless a specific exemption applies.

If a fiduciary fails to follow these five commandments, ERISA provides that the fiduciary is personally liable for any losses that result from a breach of the duties.<sup>13</sup> Fiduciaries must also disgorge any profits resulting from a breach of fiduciary duty, and there are additional civil and even criminal penalties in extreme cases.

This all sounds scary, and it is supposed to be. **And that’s why it is important that financial services firms that sell products and services to ERISA-governed plans work hard to avoid fiduciary status or take it on only with eyes wide open to the obligations.** It is also why class action plaintiff lawyers that bring ERISA cases against financial services firms always begin with an allegation that the firm has done something to trigger fiduciary status; without that, the case will quickly fall apart, because ERISA does not impose significant obligations on non-fiduciary service providers.

Let’s talk about how an insurance company and its distributors prevent fiduciary status. We always start with the point that decision-making should reside with the named fiduciaries. So, for example, the persons who decide to purchase an annuity to fund the retirement plan are fiduciaries.

I said earlier that when a plan invests in a variable annuity, the separate account supporting the contract consists of plan assets because of the “pass-through” rule. Isn’t that a problem for the insurance company? Properly structured, no. Even though the separate account assets are plan assets, the insurance company avoids any investment discretion or control and does not provide any investment advice. The plan’s fiduciaries always retain final decision-making authority to invest in the variable annuity, retain the authority to reallocate within the funds in the contract,<sup>14</sup> and retain the authority to surrender the annuity (subject to the terms the fiduciary agreed to in purchasing the contract). But it is the case that the insurance company has to be more careful in the terms of the contract where a separate account is involved.

Insurance agents and brokers that sell annuities also prevent, if they can, fiduciary status by not providing any investment advice, as ERISA defines it. It’s OK to provide investment *education* under DOL rules. DOL has rules dating back to shortly after ERISA was passed in 1974 that explain the activities that constitute fiduciary investment advice, and it is a high standard, meaning most recommendations incidental to the sale of an annuity would not be considered fiduciary investment advice. DOL’s ill-fated Fiduciary Rule was designed, in large part, to expand the activities that constitute investment advice, particularly for insurance agents and brokers.

The key thrust of ERISA is to regulate, and it’s fair to say *heavily* regulate, the conduct of fiduciaries.

Before we leave the issue of fiduciary obligations, we have to mention the prohibited transaction rules. ERISA prohibits a fiduciary from causing the plan to engage in a transaction with certain “parties-in-interest,” which includes almost every person who is involved in the plan.<sup>15</sup> ERISA also prohibits certain “self-dealing” by fiduciaries: A fiduciary may not deal with plan assets in the fiduciary’s own interest, may not act on both sides of a transaction involving the plan, and may not receive any consideration from a party dealing with the plan.<sup>16</sup> All of the prohibitions apply even if the transaction is advantageous to the plan.

ERISA’s prohibited transaction rules are so broad that almost any time a plan interacts in the commercial market, the rules could be triggered. Accordingly, most ordinary transactions operate under an exemption of some kind, whether in ERISA itself or issued by the DOL. (There is, for example, an exemption

allowing an insurance company to use its own contract to fund its in-house plan.<sup>17</sup>)

By and large, ERISA's rules are most strict when a fiduciary has a potential or actual conflict. And again, we return to DOL's ill-fated Fiduciary Rule. Because that rule would have turned brokers and agents into fiduciaries, the simple act of paying a commission in connection with the sale of an annuity contract would have violated ERISA's prohibited transaction rules, meaning every sale would need to occur under an exemption of some kind.

#### WHAT DISCLOSURES WILL BE GENERATED BECAUSE THIS PLAN HAS PURCHASED THIS ANNUITY?

Even when the issuers of annuity contracts to ERISA-governed plans are not fiduciaries, either the insurance company or the selling broker or agent must still make a number of disclosures. In addition, some disclosures must be made by the fiduciary plan administrator but effectively require information that is in the hands of the insurance company. Thus, in many cases, the implication, in terms of operations, of issuing a contract to an ERISA-governed plan is really to ensure that these disclosures are generated. The key disclosures include:

- **Schedule A of Form 5500.** Form 5500 is the annual report that most ERISA-governed plans must file with the DOL, IRS and the Pension Benefit Guaranty Corporation (PBGC) to satisfy a range of reporting requirements. Schedule A must be attached to the Form 5500 if any benefits under the plan are provided by an insurance company, including through annuity contracts. While the Form 5500 must be filed by the plan administrator, like many parts of the Form 5500, Schedule A requires information in possession of a third party, in this case the insurance company.<sup>18</sup>
- **PTE 84-24.** The vast majority of transactions that a plan undertakes may implicate what we call the prohibited transaction rules. Even the simple purchase of an annuity can cause a problem, especially if the insurance company already has a relationship with the plan. The DOL has issued an exemption, PTE 84-24, that provides relief, and it requires a disclosure to the fiduciaries of the commission and certain other information at the time of purchase of an annuity contract.
- **The service provider disclosure, also known as the 408(b)(2) disclosure.** Section 408(b)(2) of ERISA allows a plan to contract for services if (1) the services are necessary for the establishment or operation of the plan; (2) the arrangement is reasonable; and (3) no more than reasonable compensation is paid. DOL regulations require that certain "covered service providers" disclose, reasonably in advance

of entering into a contract or arrangement, information on the service provider's direct and indirect compensation, whether it will act as a fiduciary, fees for termination, and certain other information.<sup>19</sup> A commission paid to an agent or broker would be considered "indirect compensation" that would generally trigger reporting at the time of the sale of the contract. Whether this disclosure applies to the insurance company itself is less clear and depends in part on the range of services the insurance company is providing. Certain kinds of annuities, such as group variable annuity contracts used to provide plan administrative services and a platform of investments through a separate account, would trigger reporting under the service provider disclosure.

- **The participant fee disclosure, also known as the 404a-5 disclosure.** The participant fee disclosure rules require, in broad terms, that participants in plans that allow participants to allocate the investment of their own accounts (as most 401(k) plans do) receive basic information on the plan, its fees and its investments on the plan's menu.<sup>20</sup> When the plan offers an annuity investment or annuity distribution option, the disclosure must include additional specific information about the annuity. The plan administrator must provide the participant fee disclosure. In practice, however, much of the information needed to complete the disclosure is in the hands of the annuity issuer.
- **Benefit statement.** At regular intervals (the interval depends on the type of plan; for most 401(k) plans, it is quarterly), participants in plans must receive a benefit statement regarding the plan.<sup>21</sup> As with the participant fee disclosure, when the plan has invested in an annuity, the plan administrator will often need information from the issuer to complete the benefit statement.

#### A FEW WORDS ABOUT TITLE IV OF ERISA

Everything I have discussed so far comes from Title I of ERISA, which sets forth the reporting and disclosure, plan design and fiduciary responsibility rules. Life insurance companies will also interact with Title IV of ERISA, which describes the defined benefit pension insurance program, administered by the PBGC. Because defined benefit plans may not have sufficient assets to pay all liabilities, most defined benefit plans pay into the PBGC, which provides insurance if an employer is bankrupt and unable to fund its plan. But defined benefit pension plans also terminate when they are fully funded, which is called a "standard" termination. In that case, Title IV requires that the plan purchase annuity contracts from an insurance company to pay the promised benefits.<sup>22</sup> These contracts are often called "terminal funding" contracts because they fund the termination of the plan.



Once the plan is terminated, the rules of ERISA *generally* no longer apply, since there is no longer any plan and thus there are no fiduciaries overseeing the plan. The contract itself ceases to be “plan assets.” The contract must still be administered in connection with some rules that carry over from the plan, such as the requirement to pay required minimum distributions and to comply with the spousal consent rules. ERISA does allow a cause of action to be brought by the Secretary of Labor or anyone who was a participant under the plan to ensure receipt of the benefits to which the individual is entitled.<sup>23</sup> Accordingly, it is important to pay close attention to the administration of a terminal funding contract, because ERISA liabilities may still apply if former participants in the plan are not paid in full and on a timely basis.

Speaking of funding, since this is a publication for actuaries, a word about what ERISA has to say about the need to adequately fund a defined benefit plan. ERISA contains rules that parallel the minimum funding rules in the Internal Revenue Code. ERISA, being the “stick” part of retirement regulation, imposes on employers the obligation to fund the plan and imposes a lien on the employer’s real and personal assets and the assets of affiliated entities, if the required contribution is not met.<sup>24</sup>

#### WHEN DO I GET AN ERISA EXPERT INVOLVED?

ERISA should not be intimidating, once you understand that the vast majority of ERISA’s obligations fall on the employer (or whomever else has been designated as a fiduciary) sponsoring the plan. So, just because an ERISA-governed plan is in the picture does not mean you need to speed dial your ERISA expert. But I do think it is valuable to consult an expert (a) the first time the company is accepting investments from ERISA plans or selling a product to the plan market; (b) when managing plan assets and engaging in a transaction with someone who may be associated with a plan; (c) when signing agreements with ERISA warranties or covenants; and (d) when a financial service provider’s in-house plan is using proprietary investments. As with all laws, it is always better to think about compliance at the beginning, not at the end. Hopefully this “In the Beginning” article has helped the reader have enough of a compass to navigate the world of annuities in ERISA-governed plans. ■

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#### ENDNOTES

- 1 A word about DOL’s Fiduciary Rule. You may have heard that DOL’s Fiduciary Rule was such a big deal because it covered IRAs as well as ERISA-governed plans. To explain: Internal Revenue Code section 4975 contains rules that parallel some of ERISA’s rules, particularly the prohibited transaction rules described later. Because of the parallel nature, DOL has been given authority to interpret both the Code and ERISA versions of these rules. So DOL’s Fiduciary Rule would have changed the landscape for IRAs, not because they are subject to ERISA but because the prohibited transaction rules in Code section 4975 were covered by DOL’s rule.
- 2 ERISA § 4(a), (b).
- 3 For example, section 38.1133 of the Michigan Public Employee Retirement System Investment Act requires that those who manage assets of the public retirement system are fiduciaries and that they act with certain duties of care, prudence, skill and diligence very similar to the duties that ERISA imposes.
- 4 29 C.F.R. § 2510.3-3(b). The terms “H.R. 10” and “Keogh” plan come from a law passed in 1962, which was originally H.R. 10 and co-sponsored by Representative Eugene Keogh (D-NY). The law allowed self-employed individuals to save in qualified retirement plans by treating their self-employment income as qualifying compensation for plan contributions. The name stuck, and when DOL issued regulations after the passage of ERISA explaining that plans without employees are not subject to ERISA, the regulations referred to “Keogh” or “H.R. 10” plans. So, lucky Keogh has a fame that continues well past his death in 1989.
- 5 29 C.F.R. § 2510.3-2(f).
- 6 Yes, that’s right. The assumption is that the most senior executives in a company will be wearing top hats.
- 7 ERISA §§ 301(a)(3), 401(a)(1); 29 C.F.R. § 2520.104-23.
- 8 29 C.F.R. § 2510.3-102.
- 9 ERISA § 401(b)(2).
- 10 ERISA § 402(a).
- 11 You may hear people talk about an ERISA “3(21)” fiduciary as being different from a “3(38)” fiduciary. Section 3(21) of ERISA sets out the three kinds of fiduciaries in the bulleted list in the text. Section 3(38) of ERISA describes an “investment manager” who meets certain requirements. Under ERISA, if investment discretion is handed over to an investment manager who meets the requirements of section 3(38), the appointing fiduciary receives some protection for decisions that the investment manager makes. But a “3(38)” fiduciary is really just a subset of fiduciaries described in section 3(21) of ERISA.
- 12 ERISA § 404(a).
- 13 ERISA § 409(a).
- 14 In most modern 401(k) and 403(b) plans, the authority to make investment decisions is delegated to individual employees with respect to their accounts. This occurs under section 404(c) of ERISA, which provides some protection for the plan’s fiduciaries when employees have that right. In such a plan, the plan’s fiduciaries will reallocate the investments within the annuity based on the instructions of the employees.
- 15 ERISA § 406(a).
- 16 ERISA § 406(b).
- 17 ERISA § 408(b)(5).
- 18 ERISA § 103(a)(2).
- 19 29 C.F.R. § 2550.408b-2.
- 20 29 C.F.R. § 2550.404a-5.
- 21 ERISA § 105(a).
- 22 ERISA § 4041(b)(3)(A).
- 23 ERISA § 502(a)(9).
- 24 ERISA § 303(k).

# Unique Tax Issues in LTC Transactions

By Peter J. Sproul, with contributions from Peggy Hauser and Mark S. Smith

**T**ax issues with reinsurance transactions can be complicated. There are some unique tax issues associated with long-term care (LTC) transactions that make after-tax modeling crucial to economic analysis. We will explore these issues in this article.

Several insurers with closed blocks of LTC have considered exiting the business through reinsurance or stock sale transactions. In theory, it should be possible to structure a deal, whether reinsurance or stock sale, that economically works for both buyer and seller in a particular transaction on an after-tax basis.

A key challenge in structuring many LTC transactions is the tax friction cost caused by increases in nondeductible additional reserves, increases that have required additional capital to keep LTC insurers solvent. Two types of additional reserves include:

1. **Premium deficiency reserves.** Whenever a significant doubt exists as to reserve adequacy, life insurers are required to complete a gross premium valuation, which tests whether future gross premiums and reserves are sufficient to cover expected future claims and expenses. In the event inadequacy is found to exist, immediate loss recognition must be made and the statutory reserves restored to adequacy. Such increased statutory reserves are then considered the minimum reserves for that insurer. This deficiency can occur for a number of reasons, including underpricing, inadequate morbidity assumptions and low investment yields. Positive results from another line of business cannot be used to offset deficits in LTC.
2. **Asset adequacy testing (AAT) reserves.** AAT reserves typically result from some form of cash flow testing, which is a robust testing process for the purpose of assessing whether cash inflows from assets are sufficient to cover the cash outflows from the related policy liabilities. A company can offset LTC deficiencies with other product's sufficiencies only if they use a cash flow testing method to do both their AAT for LTC and all other significant lines of non-LTC business.

Whether due to cash flow testing or gross premium valuations, these additional reserves are nondeductible reserves under Section 807(d)(3)(C).<sup>1</sup> As a result, these additional reserves merely serve to increase deferred tax assets (DTAs) that may not be admissible under statutory accounting principles. Therefore, the insurer may not receive a current or deferred tax benefit to offset the surplus impact of an increase in additional reserves (although conversely there is no tax expense if and when the reserves are released, as no tax deduction was taken).

This article describes the tax friction cost caused by nondeductible reserves in reinsurance and stock transactions. Tax friction costs also arise due to negative ceding commissions and tax-deferred acquisition costs (DAC tax) under Section 848. These same tax friction costs may arise for transactions involving other types of life and health insurance business. For LTC, this tax friction cost is just exacerbated by the higher level of additional reserves often held and the low or negative appraisal values often assigned to blocks of business.

## WHAT TAX ISSUES ARISE WITH REINSURANCE OF LTC BUSINESS?

In a reinsurance transaction, assets backing statutory reserves (including nondeductible reserves) are transferred with the business (*i.e.*, the reinsurance premium is set equal to the statutory reserves and associated liabilities). In addition, a ceding commission (or negative ceding commission) is paid. From a statutory perspective, a gain or loss is recognized for the ceding commissions paid and any realized gains or losses on invested asset transfers (*e.g.*, investment securities). For the purposes of this article, we'll assume that there are no realized gains and losses on asset transfers. However, in practice, the tax impacts of realized gains or losses and statutory interest maintenance reserves being assumed as part of a transaction need consideration. We'll also assume the reinsurance is "mere" coinsurance and not part of a capital transaction (*e.g.*, a sale of a business to which goodwill applies).

For coinsurance transactions, the taxable income result is generally symmetrical for the ordinary income or loss recognized by both sides to the transaction.<sup>2</sup> The reinsurance premium paid is deductible for the ceding company and taxable to the assuming company. The tax basis of the reserves transferred creates additional taxable income for the ceding company and deduction for the assuming company. For ceding commissions paid, there can be complexity depending on the type of business and how the DAC tax rules apply. As a general matter outside of capital transactions (*e.g.*, reinsurance as part of a larger acquisition of a business to which goodwill applies under Section 1060), the goal again is symmetry as to the deduction and income recognized by both parties to the reinsurance transaction.

Because some statutory reserves are not deductible for tax purposes, the assuming company generally will recognize immediate taxable income for the difference between the statutory and tax basis reserves, as there is no offsetting deduction to its gross income from the related reinsurance premium received. The ceding company generally will have the opposite result, because there will be no taxable income from its decrease in nondeductible reserves but a deduction for the related reinsurance premium paid. This is illustrated in the following coinsurance Example 1.

This upfront tax cost for the assuming company happens on any reinsurance where the excess of the statutory over the tax reserves, as well as any DAC on the net consideration received, exceeds any positive ceding commission paid. As mentioned previously, this upfront tax friction cost of \$84 for the assuming company can be significantly exacerbated for blocks of LTC business because nondeductible reserves often make up a substantial portion of the statutory reserves, and the ceding commission may be negative instead of positive (even with high statutory reserves).

To make matters worse, the amount of general expenses that is capitalized as DAC is 9.2 percent of net premiums, because LTC

falls into the “other category” under Section 848. The combination of the statutory-tax reserve differences and DAC tax, as well as negative ceding commissions, could make many transactions unattractive to the assuming company where the tax friction cost is significant and after-tax parity cannot be achieved through a pricing adjustment, or by changing the form of the reinsurance (discussed further below). Future deductions for actual losses and amortization of DAC tax over 15 years make this a timing matter; however, the present-value cost could still be significant to the assuming company.

As a result, an assuming company may seek a pricing adjustment (often referred to as a “tax gross-up”) to compensate for its tax friction cost in assuming the business. To provide this compensation in a way that is after-tax neutral, a ceding company would need to be in a position to benefit from its deductions generated by the reinsurance transaction, including any additional payments to the assuming company for its tax friction cost.

The following tax gross-up discussion and examples are simplified and ignore considerations such as the present value of future deductions the assuming company will receive for DAC tax amortization and nondeductible reserves as they reverse over time. Any tax gross-up payment also will create additional net

Example 1  
Coinsurance Approach

**Assumptions**

Statutory reserves = 1,000  
Tax reserves = 800  
Negative ceding commission = 100  
DAC tax rate = 9.2%  
Net consideration = 1,100

Income/(Deduction)	Ceding Company	Assuming Company	
Reinsurance premium paid	(1,000)	1,000	
Decrease/(increase) in tax reserves	800	(800)	
Negative ceding commission paid	(100)	100	
DAC (1,100 @ 9.2%)	(101)	101	
<b>Taxable (loss)/income</b>	<b>(401)</b>	<b>401</b>	
Tax (benefit)/expense @ 21%	(84)	84	

**Reconciliation of statutory to taxable income:**

Statutory (loss)/gain before taxes	(100)	100	Ceding commission paid
Nondeductible reserves	(200)	200	Difference between the statutory and tax reserves transferred
DAC	(101)	101	
<b>Taxable (loss)/income</b>	<b>(401)</b>	<b>401</b>	

consideration subject to DAC tax that complicates any attempt to achieve after-tax parity. The relative tax positions of both parties will factor into any tax gross-up payment. For example, an assuming company with net operating losses (NOLs) may be able to use those losses to offset its immediate taxable income and any tax expense resulting from the reinsurance transaction.

This tax gross-up concept is illustrated in Example 2, which uses the same facts from Example 1 and includes the additional tax gross-up payment.

If the ceding company cannot immediately benefit from its taxable loss, the tax gross-up payment may not create after-tax parity. For example, if the taxable loss generates additional NOLs to carry over to future years, the ceding company has no reduction in its current tax expense and will only receive a deferred tax benefit in statutory surplus to the extent its deferred tax asset for the NOLs is admissible. In the example, the after-tax loss and reduction in surplus therefore could be much higher (worst case, \$207 with no current or deferred tax benefit).

To ease the tax friction cost for the assuming company, the type of reinsurance also could be changed to funds withheld (FWH) or modified coinsurance (Modco), where the upfront DAC tax effect is lessened (FWH and Modco) or the statutory and tax basis reserves do not actually transfer (Modco only). For example, the upfront DAC tax effect is lessened as the net reinsurance consideration subject to capitalization under Section 848 is reduced by the increase in the FWH or Modco “loan” for the assets still held by the ceding company.<sup>3</sup> In Modco, there also is no upfront tax deduction (ceding company) or income (assuming

company) for the lower tax basis in the statutory reserves as they are not being transferred. Instead, the ceding company retains the Modco reserves and any related statutory-tax basis difference.

Example 3 illustrates a Modco approach. This example uses the same facts as in the previous examples, except that the statutory and tax basis reserves do not transfer to the assuming company and all that is paid upfront is the negative ceding commission of \$100.

As compared to Example 2, the tax gross-up is lower to achieve the same after-tax result. The statutory and tax reserves staying with the ceding company results in no immediate taxable income for the assuming company and a lower DAC tax amount with less consideration paid.

In summary, unless the right tax profiles exist to enable the ceding company to realize the tax benefits of deductions created by the transaction (or to enable the assuming company to offset its upfront taxable income created by the transactions), the tax friction cost could become too unpalatable to either party to the proposed reinsurance transaction.

#### HOW ARE THE ISSUES DIFFERENT IN A STOCK SALE TRANSACTION?

What if an insurance company with LTC, or other lines or business with nondeductible reserves and low or negative appraisal values, is being purchased in a stock transaction?

The U.S. federal tax rules applicable to stock sale transactions are different than for reinsurance transactions and can be complex, especially when selling a company that has experienced losses

#### Example 2 Coinsurance With Tax Gross-up Payment

Income/(Deduction)	Ceding Company	Assuming Company
Immediate taxable (loss)/income per Example 1	(401)	401
Tax gross-up payment [401 × (tax rate)/(1-tax rate)]	(107)	107
<b>Revised taxable (loss)/income</b>	<b>(508)</b>	<b>508</b>
Revised tax (benefit)/expense @ 21%	(107)	107

**After-tax gain/(loss):**

Negative ceding commission paid	(100)	100
Tax gross-up payment (i.e., tax pricing adjustment)	(107)	107
Total (loss)/gain before taxes	(207)	207
Less: tax benefit/(expense) per above	107	(107)
<b>After-tax (loss)/gain</b>	<b>(100)</b>	<b>100</b>

Example 3  
Modco Approach

**Assumptions**

Modco reserves = 1,000 (equals the statutory reserves)

Net consideration = 100 (ignores tax gross-up payment)

Income/(Deduction)	Ceding Company	Assuming Company	
Reinsurance premium paid	(1,000)	1,000	
Modco reserves adjustment	1,000	(1,000)	
Negative ceding commission paid	(100)	100	
DAC (100 @ 9.2%)	(9)	9	
Taxable income/(loss) before tax gross-up	(109)	109	
Tax gross-up payment [109 × (tax rate)/(1-tax rate)]	(29)	29	
<b>Taxable (loss)/income</b>	<b>(138)</b>	<b>138</b>	
Tax (benefit)/expense @ 21%	(29)	29	

**Reconciliation of statutory to taxable income:**

Statutory (loss)/gain before taxes (Ceding Commission plus Tax Gross-up)	(129)	129	Ceding commission plus tax gross-up
Nondeductible reserves	–	–	Reserves not transferred
DAC	(9)	9	
<b>Taxable (loss)/income</b>	<b>(138)</b>	<b>138</b>	
<b>After-tax gain/(loss)</b>	<b>(100)</b>	<b>100</b>	\$129 statutory loss before tax less \$29 tax benefit

(a “loss company”). However, they may provide more flexibility compared to a reinsurance transaction. A deep technical analysis on the stock sale tax rules is beyond the scope of this article. The following discussion will focus more on the key concepts and how the tax result compares with a reinsurance transaction.

A sale of stock ordinarily generates a capital gain or loss for the seller and carryover tax basis in the assets of the target company. For loss companies with unused tax attributes (e.g., NOLs), there are rules to prevent companies being sold for their tax attributes. The most well-known is the annual limitation placed on the use of NOLs at the time of an ownership change under Section 382. The annual limitation amount is generally the value of the company at the time of the ownership change multiplied by the long-term tax-exempt interest rate. For a loss company that has no or minimal value, any tax attributes that remain with the company therefore become worthless to a buyer. This limitation can also apply to certain unrealized or “built-in” tax losses at the time of the ownership change.

As a general statement, a better outcome is achieved if the seller can use or retain its tax attributes that would otherwise be

worthless in the hands of a buyer. This may not always be possible. There is a joint tax election available under Section 338(h) (10) for the seller and buyer to treat a qualifying stock sale as an asset sale for tax purposes. This may allow the seller to retain and use tax attributes of the target company (not transferred in an asset sale), as well as generate ordinary losses in place of a capital loss on the stock. This gets complex and would need to be modelled for both sides to the transaction. Generally, the deemed asset sale treatment for a target company with no or minimal value will generate a tax friction cost for a buyer. At a high level, this tax friction cost results from the buyer inheriting a reduced or “stepped-down” tax basis in the target company’s assets and potentially recognizing immediate taxable income for reestablishing DAC tax on the net consideration deemed to be transferred in the hypothetical assumption of the insurance liabilities.

Before we go any deeper into the woods, let’s go back to the same fact pattern as used in Example 1. Let’s assume the negatively valued business with nondeductible reserves is all that is owned by the target company. The target company has no tax attributes or built-in losses subject to limitation under Section 382.

In a stock sale, the seller’s capital loss will reflect its difference between the sale proceeds (assumed none or minimal) and its adjusted tax basis in the stock. The seller’s stock basis will reflect what it paid for the stock, plus capital contributions, less distributions, and any adjustments for taxable earnings or losses already reflected in the seller’s consolidated tax return. Where the seller has had to contribute capital to fund additional nondeductible reserves, this will have increased its tax basis in the stock while no deduction has yet to be recognized by the target company. Upon the sale of the stock, the seller will therefore recognize a capital loss for the capital contributed to fund the nondeductible reserves, as well amounts contributed for the negative valuation.

This is illustrated in Example 4, using the same facts in Example 1 (Note: the \$100 negative ceding commission is now additional capital contributed prior to sale).

Example 4  
Stock Sale

Statutory reserves & liabilities = 1,000 (including 200 nondeductible additional reserves)	
Total assets = 1,100	
Net assets = 100	
Capital contributed = 300	
Deficit in surplus = 200	
Net capital & surplus = 100	
Stock purchase price = 0	
Seller stock sale proceeds	0
Less: adjusted stock basis (equals capital contributed)	(300)
<b>Capital gain/(loss) on sale of target’s stock</b>	<b>(300)</b>

The \$300 capital loss is effectively the capital contributed to fund the \$100 negative valuation and the \$200 of additional nondeductible reserves.

Compare this capital loss to Example 1, where the ceding company recognized a \$401 taxable loss. The loss before taxes in the stock sale is economically the same as in the reinsurance scenario of Example 1. For tax, there are two differences: (1) The reinsurance loss is ordinary, not capital; and (2) the reinsurance transaction generated an additional \$101 DAC tax deduction. Especially if the seller cannot use its capital loss,<sup>4</sup> the reinsurance result looks to be the better tax outcome for the seller. However, in the stock sale, the buyer is not recognizing immediate taxable income, so its tax friction cost is lower. The comparison of the after-tax outcomes will depend on the seller being able to use its capital loss. If it can, its after-tax loss could be lower than where the buyer would not require a tax gross-up. Both scenarios need

modelling to truly compare, but the differences in the tax result and any pricing adjustment could be starkly different.

**Unified Loss Rules**

A final twist and complication for a stock sale is the unified loss rules. In our fact pattern, the nondeductible reserves may pose a challenge and create a tax friction cost for the buyer.

The unified losses rules (ULR) are U.S. federal tax rules intended to prevent two taxpayers from both obtaining a deduction for the same single economic loss (a duplicated loss).<sup>5</sup> The ULR rules are complex and apply to selling a member of a consolidated tax return. A full discussion of these rules is beyond the scope of this article.

To determine whether there is a duplicated loss, the ULR generally compare the seller’s net tax loss on the stock (the outside loss) to the net tax loss that would be realized on the sale of target company’s net assets (the inside loss). The lesser of the outside and inside loss is viewed as the single economic loss that could be deducted twice, first on the stock sale by the seller and later by the buyer through the buyer inheriting an unrealized tax loss in the target company’s assets. This amount is the tax attribute reduction that must be applied to reduce the buyer’s inherited tax attributes and tax basis in the assets of the acquired company. The reduction amount is applied under ordering rules that first reduce tax attributes and then reduce the tax basis in company’s assets (except for cash).<sup>6</sup>

This is illustrated in Example 5, using the same facts as in Example 4.

Example 5  
Unified Loss Rules

Tax basis in assets	1,100
Less: Tax basis in reserves & liabilities	(800)
<b>Net “inside” tax basis</b>	<b>300</b>
Value of the stock being sold	0
<b>Aggregate inside gain/(loss) [=A]</b>	<b>(300)</b>
Net capital gain/(loss) on stock sale per Example 4 [=B]	(300)
Potential duplicated tax loss (lower of A & B)	<b>300</b>

The duplicated loss would be applied to reduce the buyer’s tax basis in the assets of the target company from \$1,100 down to \$800. This is to prevent the buyer from benefitting in the future from a deduction of \$300 for the same economic loss recognized by the seller on the stock sale. In ULR theory, the buyer has inherited a company with \$300 of losses not yet recognized



for tax purposes. Rather than reduce this future loss, the rules instead require the recognition of additional taxable gains on the assets. While this may appear to be a wash, in reality for the insurance company, it may not wash over time to the extent the gains and losses are recognized in different taxable years. For example, some of the assets with a reduced tax basis (e.g., receivables) may be settled in a relatively short time period and require the company to pay tax on gains now with future losses that cannot be carried back to recover the additional taxes paid.

Where nondeductible reserves are significant, it is not uncommon for this tax basis reduction to reduce the buyer's inherited tax basis in the invested assets of the target company. This, therefore, can impact a buyer's intention with regard to re-positioning the invested assets post-acquisition, as selling the invested assets will accelerate taxes payable on the higher tax gain.

There is some good news.

The duplicated loss provisions in Treas. Reg. § 1.1502-36(d)(6) allow the seller to elect to reduce its stock basis and resulting capital loss. This reduces the duplicated loss and allows the buyer to preserve dollar-for-dollar its net inside tax basis in the assets of the acquired company. Therefore, if the seller does not expect to use all of its capital loss, the seller and the buyer may be able to reach an agreement allowing both sides to optimize their outcomes. Also, there are tax elections under these provisions that would allow the seller to reattribute certain tax attributes to itself in lieu of capital losses on the stock sale, similarly allowing

the buyer to potentially preserve its inherited tax basis in the assets of the acquired company.

Ultimately, this flexibility that the ULR affords may present the best outcome for both parties to a sale transaction involving LTC or lines of business with a similar profile.

## CONCLUSION

The income tax effects can heavily distort deal economics for LTC transactions. The after-tax economics need to be modeled and analyzed to fully assess the tax impact of different forms of a transaction that may achieve the same pre-tax result. Changes in the form of the transaction could significantly alter the tax effects, and certain tax elections may be available to achieve the best outcome for both sides. Future surprises can also be avoided (e.g., reductions in surplus due to higher tax costs) and enable informed decisions before entering into transactions. ■

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## ENDNOTES

- 1 References to "Section" and "§" are to sections of the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." references are to the regulations promulgated thereunder.
- 2 See Treas. Reg. § 1.817-4(d), referring to transactions not involving a capital sale or exchange. For an assumption reinsurance transaction, whether actual or deemed, the taxable income result is not symmetrical where the buyer would need to capitalize certain consideration paid and defer deductions, while the seller would immediately recognize its gain or loss.
- 3 See Treas. Reg. § 1.848-2(f)(5).
- 4 For US Federal tax purposes, a capital loss is generally harder to use because it can only offset capital gains and expires if not used after five years. Ordinary losses can offset ordinary income and capital gains and no longer expire beginning with NOLS generated in 2018 (except for nonlife insurance companies).
- 5 In particular, the duplicated loss provisions in Treas. Reg. § 1.1502-36(d) must be considered.
- 6 See Treas. Reg. § 1.1502-36(d)(4) for the tax attribute reduction rules.

# Planning Ahead: Revenue Procedure Could Help Separate Accounts Comply With Section 817(h) When Investing in a New Type of Mortgage-Backed Securities

By Bryan W. Keene and John T. Adney

Last October, the IRS issued Revenue Procedure 2018-54,<sup>1</sup> addressing the treatment of certain new residential mortgage-backed securities (MBS) under the section 817(h)<sup>2</sup> investment diversification requirements. Life insurance companies have traditionally been major investors in mortgage instruments, including the MBS issued by the Federal National Mortgage Association (Fannie Mae) and similar securities issued by the Federal Home Loan Mortgage Corporation (Freddie Mac), and so the IRS's focus on such investments by life insurers is not surprising.<sup>3</sup> Indeed, after the enactment of section 817(h) in 1984, authorizing regulations prescribing minimum standards for diversification of the investments of insurers' separate accounts supporting nonqualified variable annuity and life insurance contracts, the statute was amended in 1988 to make clear that each U.S. government agency or instrumentality was to be treated as a "separate issuer" of securities under those regulations.<sup>4</sup> The specific purpose of the amendment, which overturned a rule in proposed regulations, was to enable insurers to satisfy the diversification requirements when their separate account portfolios consist primarily of Fannie Mae, Freddie Mac and other government agency securities, such as in a government bond fund.<sup>5</sup>

Under the section 817(h) regulations, the investments of a life insurer's separate account or subaccount—technically a "segregated asset account," in the terminology of the regulations—must meet a minimum diversification standard in order for the holder of a nonqualified variable annuity or life insurance contract based on that account to receive the normal income tax treatment accorded to such a contract. That standard

generally requires that no more than 55 percent of the account's investments be attributable to any one "issuer," no more than 70 percent to any two issuers, and so on.<sup>6</sup> Hence, to apply this standard, an insurer must be able to identify the issuer of the securities in which its separate account invests. As explained below, in the case of certain derivatives (specifically, forward contracts) involving a new type of Fannie Mae and Freddie Mac security that is being developed, the issuer of the securities ultimately delivered in the transaction could be either of those entities. This new guidance attempts to address the temporary uncertainty over who will be the issuer of the delivered securities, which could have presented some planning difficulties for investment managers responsible for diversification compliance.

## THE PROBLEM AND THE SOLUTION, IN BRIEF

Under the direction of the Federal Housing Finance Agency (FHFA), Fannie Mae and Freddie Mac have been working on a "Single Security Initiative" that will conform the terms of the mortgage-backed securities they issue. Prior to this initiative, Fannie Mae and Freddie Mac had issued MBS with terms specific to each, and one goal of the initiative is to make Fannie Mae and Freddie Mac MBS fungible on a forward market for such securities, known as the "To-Be-Announced" or "TBA" market, to enhance liquidity for loan originations and to reduce borrowing costs for home buyers. Once the initiative is launched on June 3, 2019, investors will be able to enter into forward contracts to purchase these securities—called "Uniform Mortgage-Backed Securities" or "UMBS"—without specifying Fannie Mae or Freddie Mac as the issuer.<sup>7</sup> Thus, the securities actually delivered under TBA contracts for UMBS could be issued by Fannie Mae, Freddie Mac or a combination thereof. Hence, the issuer(s) of the UMBS to be delivered to an insurer's separate account under TBA contracts for the UMBS will not be known until close in time to their delivery, presenting a potential challenge where compliance with the diversification requirements is concerned.<sup>8</sup>

This difficulty was called to the attention of the Treasury Department and the IRS early in 2018, prompting the IRS's issuance of Revenue Procedure 2018-54 on Oct. 16, 2018. In brief, Revenue Procedure 2018-54 addresses this issue by allowing a life insurance company, or an "insurance-dedicated fund" (IDF)<sup>9</sup> in which the insurer's separate account invests, to elect up-front to treat the securities that will be delivered under TBA contracts in UMBS transactions as being issued proportionally by Fannie Mae and Freddie Mac for section 817(h) diversification testing purposes. The proportion to be used in the testing will be published annually by the FHFA, based on historical data and expressed as a ratio, and the ratio that applies when the TBA contract is entered into will remain constant for all securities delivered under that contract.



## DETAIL ON THE NEW GUIDANCE

Let's look further at the details of this new election and its consequences.

### The New Election

Under Revenue Procedure 2018-54, the proportional assumption as to the UMBS issuers applies if a “taxpayer” makes a “deemed-issuance-ratio” election with respect to its “generic GSE [government sponsored enterprise] securities.” For this purpose, a “taxpayer” is defined as “(1) An insurance company that issues variable contracts within the meaning of § 817(d); and (2) An investment company, partnership, or trust . . . that qualifies for ‘look-through’ treatment under § 1.817-5(f).”<sup>10</sup> The taxpayer involved must file the election with its tax return for the first taxable year in which it wants the election to apply, adhering to the election form requirements spelled out in the revenue procedure,<sup>11</sup> and the election will continue to apply to all subsequent years unless the IRS agrees to a revocation request through a private letter ruling.<sup>12</sup> If the taxpayer joins in the filing of a consolidated return, the entity filing the return must specify which member or members of the group are making the election.<sup>13</sup>

The definition of “taxpayer” presents some ambiguity under these circumstances because both the insurance company and the IDF are treated as “taxpayers” that could potentially make conflicting elections. For example, consider an IDF that offers access to the fund through multiple insurance companies. The IDF may make an election under the revenue procedure, while an insurance company with separate accounts invested in the fund does not. Under these circumstances, which election controls? How are the diversification rules applied? Alternatively, if an IDF declines to make an election, can the insurance company effectively force the IDF's hand by making the election itself?

### Securities Covered by the Election

A generic GSE security that can be covered by the election is defined in Revenue Procedure 2018-54 as (1) a security issued by Fannie Mae or Freddie Mac; (2) which is eligible for purchase in the TBA market; (3) which the buyer acquires through a TBA contract (or, if certain conditions are met, the buyer acquires through an assignment of a TBA contract before the parties know the identities of the actual issuers or acquires through a corporate acquisition); and (4) as to which the buyer has “no way of knowing the actual issuer(s) of the securities to be delivered under the contract” at the time the contract is entered into.<sup>14</sup> The revenue procedure's definition generally describes a so-called “unstipulated” trade of a UMBS on the TBA market, but the procedure expressly excludes “stipulated” trades and similar transactions where the issuer of the securities to be delivered is known in advance.<sup>15</sup>

### Treatment of Securities Covered by the Election

Based on this election, a generic GSE security is deemed for section 817(h) purposes to be issued in part by Fannie Mae and in part by Freddie Mac, regardless of which one actually issued the securities delivered under the TBA contract. This treatment applies to generic GSE securities held directly by a segregated asset account and those held indirectly through an IDF.<sup>16</sup> The “deemed-issuance ratio” that applies when the TBA contract is entered into (more on this below) determines the portions deemed to be issued by Fannie Mae and Freddie Mac;<sup>17</sup> this ratio continues to apply thereafter to all securities delivered under that TBA contract for as long as the separate account (or IDF) holds them.<sup>18</sup> Electing taxpayers presumably will need to track the deemed issuers of the generic GSE securities delivered under different TBA contracts using different deemed-issuance ratios and differentiate those from other securities issued by Fannie Mae or Freddie Mac that the new guidance does not cover. This may prove to be no easy task.

### Determination of the Deemed-Issuance Ratio

The deemed-issuance ratio is to be published by the FHFA at least three weeks before the start of each calendar year. The revenue procedure recites that the FHFA will determine the ratio based on the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during the 24-month period ending not earlier than Oct. 31 immediately preceding the year in which the new ratio will apply, subject to certain rounding rules.<sup>19</sup>

### Effective Date of the Guidance

The guidance provided by Revenue Procedure 2018-54 “is effective for elections with respect to quarters ending on or after the date on which investors can first enter into TBA contracts that do not specify the issuer of the GSE securities that may be delivered under it” (*i.e.*, TBA contracts issued under the UMBS initiative).<sup>20</sup> The quarter-end date is referenced because the section 817(h) diversification testing is performed at the end of each calendar quarter. The UMBS initiative is expected to go live on June 3, 2019.<sup>21</sup>

## CONCLUDING THOUGHTS

The TBA market, as noted, serves to provide liquidity for loan originations and help lower borrowing costs; and in issuing the revenue procedure, the Treasury and the IRS recognize the important role the insurance industry plays in the TBA market. Many companies, however, are still evaluating whether they will make the election, given the administrative complexity in doing so. And as with other guidance, some questions are still left open. For example, does an insurance company's election affect the securities it is treated as holding through an IDF or just the securities it holds directly, such as through a managed account? Also, while the revenue procedure clearly addresses

the treatment of UMBS assets once they are actually delivered pursuant to a TBA contract, it does not discuss the treatment of the TBA contract itself prior to delivery of the referenced securities.

In that regard, it is not entirely clear who the “issuer” of an outstanding forward contract or similar derivative is for purposes of section 817(h). For example, it could be the counterparty to the derivative contract, or it could be the entity that issued (or will issue) the underlying security the derivative references.<sup>22</sup> Revenue Procedure 2018-54 does not shed any additional light on this question, at least directly. However, if a taxpayer determines generally that for purposes of section 817(h) it is appropriate to treat an unsettled forward contract as issued by the issuer of the referenced security and the taxpayer has made an election under the revenue procedure with respect to the UMBS that will be delivered under its TBA contracts, then perhaps the taxpayer could apply the deemed-issuance-ratio treatment to those TBA contracts even while they remain unsettled. Again, the guidance

does not expressly provide for such treatment. As a result, further clarification may be needed. As is often the case, guidance could beget more requests for guidance. ■

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#### ENDNOTES

- 1 2018-45 I.R.B. 769.
- 2 Unless otherwise indicated, references to “section” are to sections of the Internal Revenue Code of 1986, as amended (the Code).
- 3 The mortgage-backed securities that Freddie Mac issues are called “participation certificates” rather than “mortgage-backed securities.” For ease of discussion, we refer to both as “MBS” throughout this article.
- 4 See I.R.C. section 817(h)(6). The regulations appear as Treas. Reg. section 1.817-5, promulgated in T.D. 8242, 1989-1 C.B. 215. The purpose of both the statute and the implementing regulations, according to the legislative history of the enactment, essentially was to bolster the “investor control” doctrine that the IRS had articulated in a series of revenue rulings. See Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 211(a) (1984) (adding section 817(h) to the Code); H.R. CONF. REP. NO. 98-861, at 1055 (1984) (providing legislative history on the purpose of section 817(h)). The investor control doctrine is addressed in Rev. Rul. 2003-92, 2003-2 C.B. 350, *clarified and amplified* by Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 82-55, 1982-1 C.B. 12; Rev. Rul. 81-225, 1981-2 C.B. 12, *clarified and amplified* by Rev. Rul. 2007-7, 2007-1 C.B. 468, and Rev. Proc. 99-44, 1999-2 C.B. 598; Rev. Rul. 80-274, 1980-2 C.B. 27; and 77-85, 1977-1 C.B. 12. See also *Webber v. Commissioner*, 144 T.C. 324 (2015); *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984).
- 5 H. REP. NO. 100-1104, at 176 (Conf. Rep.). Regulated investment companies (mutual funds) are subject to similar diversification requirements as variable contracts. However, the mutual fund rules allow for unlimited investments in government securities, whereas the variable contract rules subject government securities to the same diversification standards as other types of securities (albeit with the special rule described that treats each agency or instrumentality as a separate issuer). See generally section 851(b)(3).
- 6 Technically, the diversification rules impose percentage limits on a segregated asset account’s “investments.” For this purpose, however, the regulations provide that “[a]ll securities of the same issuer . . . are each treated as a single investment.” Thus, the limits effectively apply to “issuers.” See Treas. Reg. section 1.817-5(b)(1)(i) and (ii).
- 7 Freddie Mac, Single Security and the Common Securitization Platform (CSP), available at <http://www.freddiemac.com/mbs/single-security/#overview>.
- 8 The diversification test must be met only on the last day of each calendar quarter, and if it is not met on that day the manager has the next 30 days to comply. See Treas. Reg. section 1.817-5(c)(1). Thus, one would think that if the securities delivered in a TBA transaction cause a diversification problem, the manager would have plenty of time to address it. We understand that one concern with such an approach is that it would require the manager to liquidate or exchange the delivered securities for those of another issuer (for example, Fannie Mae for Freddie Mac), which could involve transaction costs and frustrate the FHFA’s goals under the Single Security Initiative to enhance liquidity for loan originations and to reduce borrowing costs for home buyers.
- 9 The diversification test is applied by looking through any IDF in which a segregated asset account invests and treating the IDF’s assets as held by the account. An IDF is a regulated investment company, real estate investment trust, partnership or grantor trust in which all beneficial interests are held by one or more segregated asset accounts and to which public access is available only through the purchase of a variable contract (with certain exceptions).
- 10 Section 3.01 of Rev. Proc. 2018-54 (sections of the procedure are hereinafter abbreviated as “RP sec.”).
- 11 RP sec. 7.01.
- 12 RP sec. 7.02 and 7.03.
- 13 RP sec. 7.01.
- 14 RP sec. 3.03 and 3.04.
- 15 RP sec. 3.05.
- 16 RP sec. 6.01.
- 17 RP sec. 6.02.
- 18 RP sec. 6.03. Special rules apply if a generic GSE security is part of a “resecuritization program” that results in new securities being issued. RP sec. 6.04.
- 19 RP sec. 6.05.
- 20 RP sec. 8.
- 21 See *supra* note 7 and accompanying text.
- 22 Compare Rev. Rul. 83-69, 1983-1 C.B. 126 (treating publicly traded call options as “issued” by the issuer of the underlying security, not the counterparty, for purposes of the mutual fund diversification rules in section 851(b)(3)) and Treas. Reg. section 1.817-5(h)(2) (defining “Treasury security” for certain purposes of the variable contract diversification rules under section 817(h) as excluding put and call options on such securities). Apart from the foregoing regulation, we are not aware of any guidance directly addressing the treatment of derivatives for purposes of section 817(h). See also PLR 9125038 (Mar. 27, 1991; treating the counterparty as the issuer of a repurchase agreement for purposes of section 817(h)).



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# LB&I Directive Provides Safe Harbor for AG43 and PBR for Pre-TCJA Years

By Samuel A. Mitchell and Arthur C. Schneider

The Large Business and International Division (LB&I) of the Internal Revenue Service (IRS) recently resolved a third significant issue with the insurance industry through the Industry Issue Resolution Program (IIR) procedure outlined in Revenue Procedure 2016-19.<sup>1</sup> Readers will remember the LB&I Directive providing a safe harbor for bad debts related to structured securities in 2012<sup>2</sup> and the Directive providing a safe harbor method of accounting for Variable Annuity hedging related to Guaranteed Minimum Benefits (GMxB) in 2014.<sup>3</sup> This time, LB&I married the IIR program with its Campaign examination program to address the tax treatment under Internal Revenue Code (I.R.C.) § 807 of stochastic reserves under Actuarial Guideline XLIII (AG 43)/Valuation Manual 21 (VM-21) for variable annuities and for Principle-Based Reserves (PBR) under VM-20. The guidance, which applies only to reserves for tax years 2010 through 2017, comes in the form of LB&I Directive *IRC Section 807: Large Business and International (LB&I) Directive Related to Principle Based Reserves for Variable Annuity Contracts (AG 43/VM-21) and Life Insurance Contracts (VM-20)*, LB&I-04-0818-015 (Aug. 24, 2018). This article provides a top-level overview of the Directive.

## BACKGROUND ON TAX DEDUCTIBILITY OF PRINCIPLE-BASED RESERVES

The Tax Cuts and Jobs Act of 2017 (TCJA),<sup>4</sup> effective for tax years 2018 and following, provides that reserves determined under the Commissioners' Reserve Valuation Method (CRVM) for life insurance contracts and the Commissioners' Annuity Reserve Valuation Method (CARVM) for annuities, as prescribed by the National Association of Insurance Commissioners (NAIC) as of the date the reserve was determined, are deductible under I.R.C. § 807, subject to a haircut.<sup>5</sup> Thus, to the extent CRVM/CARVM or other NAIC-prescribed method encompasses principle-based reserving methodologies, those principle-based reserves (after appropriate haircut) are deductible for tax purposes. This new statutory framework abandons the prior law requirements that reserves must be determined based on the CRVM/CARVM that was in existence on the date the contract was issued based on



prescribed interest rate and mortality assumptions also determined as of the date the contract was issued.<sup>6</sup> In the place of the old fixed-at-issue assumptions, the new framework conforms the calculations to the NAIC-prescribed methods at the time of determination, which in most cases will be based on statutory accounting (with the prescribed haircut).<sup>7</sup>

The new law for reserve computations could be viewed as a clarification that principle-based reserves determined under CRVM or CARVM in general are deductible under I.R.C. § 807. However, before the TCJA, there were some issues regarding whether principle-based reserves were deductible and, if so, how the calculations were to be made under the fixed-at-issue mortality and interest rate assumptions required under prior law. In Notice 2010-29,<sup>8</sup> the IRS took the position that the reserve for variable annuities (VA Contracts) with guaranteed minimum benefits (GMxBs) was limited to the Standard Scenario Amount (SSA) determined using prescribed interest rates and mortality assumptions and that the excess stochastic portion of the reserve under AG 43 (*i.e.*, the excess Conditional Tail Expectation Amount, or CTE Excess) was not included in the deductible reserve. The Notice applied only to contracts issued on or after Dec. 31, 2009, which was the effective date of AG 43 for statutory accounting purposes. The Notice did not address the tax method for determining the reserves for contracts that had been issued before Dec. 31, 2009, and were subject as of the date of issuance to Actuarial Guideline XXXIV (AG 34) for VA

Contracts with guaranteed death benefits and Actuarial Guideline XXXIX (AG 39) for VA Contracts with guaranteed living benefits. The Notice was only interim in nature and requested comments regarding the status of principle-based reserves.

*TAXING TIMES* has published articles that readers may want to revisit to gain a more detailed understanding of the issues dealt with under prior law and in Notice 2010-29. The March 2016 issue explains why the CTE Excess under AG 43/VM-21 and the stochastic reserve under VM-20 should qualify as a deductible tax reserve under former I.R.C. § 807.<sup>9</sup> The June 2016 issue provides a follow-up discussion of why the deterministic reserve under VM-20 for life insurance contracts likewise should be deductible under the former version of I.R.C. § 807.<sup>10</sup> A major point made in the articles was that principle-based reserves qualify as life insurance reserves under I.R.C. § 816 because they are actuarially determined amounts that are established to satisfy future unaccrued claims. Furthermore, the articles point out that the reserves are an integral part of the CARVM (in the case of the AG 43/VM-21 CTE Excess) and CRVM (in the case of VM-20 deterministic and stochastic reserves) methods for determining amounts to set aside to satisfy future unaccrued claims and therefore were required to be accounted for as part of life insurance reserves under prior law. Other issues revolved around how to make adjustments to the PBR concepts to fit within the fixed-at-issue requirements under prior law for interest rates and mortality assumptions. Several viable options for accomplishing this were discussed in the prior *TAXING TIMES* articles.

#### IIR AND LB&I CAMPAIGN EFFORT

By letters dated Aug. 23, 2016, a group of life insurance companies and the American Council of Life Insurers (ACLI) requested an IIR effort under Rev. Proc. 2016-19 to address the deductibility under I.R.C. § 807 of the CTE Excess amount under AG 43/VM-21 for VA Contracts with GMxBs issued after 2009 and the deterministic and stochastic reserves under VM-20 for life insurance contracts.<sup>11</sup> By the letter dated Nov. 10, 2016, LB&I accepted the request into the IIR program and agreed to work with the industry group and the ACLI to address the issues. In January 2017, LB&I also added the issues addressed in the IIR to its list of examination “Campaigns” under its then-new procedures for strategically focusing on identified issues that either present compliance issues or that otherwise could be dealt with in a manner that most efficiently utilizes IRS examination resources.<sup>12</sup>

Throughout 2017 and into 2018, industry representatives met several times with the IRS team to present the industry’s positions and to address questions and comments. The effort gained significant steam, and perhaps was put on an easier road to resolution, when the TCJA was enacted in December 2017, and it became clear that the most difficult issues addressed in the

IIR/Campaign were limited to tax years before 2018 because the new rules for determining reserves are no longer based on the actuarial assumptions as of the date of issuance. It also became clear during the IIR process that the LB&I team wanted to implement a solution using a true-up mechanism on the 2017 tax return and did not want to deal with processing amended tax returns from, or making examination adjustments to, prior years. The IIR dialogue culminated with the issuance of the Directive in August 2018, just in time for inclusion on the 2017 tax returns. The Directive provides safe harbors for the treatment of pre-2018 tax reserves, to be implemented on the 2017 return on a cumulative basis, with spread amounts into future years in certain circumstances.

By all indications, the IIR process accomplished what it was intended to—that is, resolution of complex industry-wide issues on a basis mutually acceptable to the IRS and a large portion of the industry.

#### THE LB&I DIRECTIVE

The following describes in general the scope and operation of the Directive that resulted from the IIR/Campaign process.

##### Scope

The Directive may be implemented separately for VA Contracts with guaranteed minimum living benefits (GMLBs) issued before Dec. 31, 2009 (pre-2010 contracts),<sup>13</sup> and VA Contracts with GMxBs of any type that were issued after that date (post-2009 contracts), as to tax years 2010 through 2017.<sup>14</sup> It also applies to life insurance policies issued in 2017 if VM-20 was reported in 2017 on the company’s NAIC Annual Statement. The necessary adjustments for VA Contracts are to be taken into account either entirely on the 2017 tax return or on the 2017 tax return and subsequent tax returns if 10-year spread amounts apply as described below. If the Directive is implemented, only limited ministerial-type adjustments to original returns (processable adjustments) are permitted for pre-2017 tax years. If the Directive is implemented for post-2009 contracts, then it also must be implemented on the 2017 tax return for life insurance contracts subject to VM-20 that were reported pursuant to VM-20 on the company’s 2017 NAIC Annual Statement.<sup>15</sup>

The ultimate scope of the Directive nicely illustrates one of the best aspects of the IIR program—an ability to resolve difficult

industry-wide issues on a comprehensive basis. During the process, LB&I placed importance on the Directive applying (1) to contracts subject to VM-20 as well as those subject to AG-43/VM-21, (2) to pre-2010 VA Contracts, and (3) on the 2017 tax return. As noted above, the first two objectives were greatly facilitated by enactment of TCJA's reserve computational rules for post-2017 taxable years. Life insurance companies were interested in bringing pre-2010 contracts within scope but only if the option was available to implement the Directive separately for those contracts and for post-2009 contracts. In the end, the objectives on both sides were satisfied.

### Tax Reserve Safe Harbors

For VA Contracts, the safe harbor tax reserve is equal to the SSA adjusted for interest and mortality assumptions under former I.R.C. § 807(d), plus 96 percent of the **statutory** CTE Excess over the (non-tax-adjusted) SSA.

For life insurance contracts subject to VM-20 and reported under VM-20 on the 2017 Annual Statement, the safe harbor tax reserve is equal to the Net Premium Reserve (NPR) adjusted for interest, mortality, and deferred and uncollected premiums under former I.R.C. § 807(d), plus 96 percent of the allocated **statutory** excess of the deterministic and/or stochastic reserve over the (non-tax-adjusted) NPR.

### Consistency/Consolidated Basis

The election<sup>16</sup> to implement the Directive safe harbors and the determination of the earliest open year are to be made on a consolidated basis, and all companies in the group are to be treated consistently. However, the safe harbor calculations, implementation adjustments (including the 10-year spread adjustments), and certifications are to be done on a company-by-company basis.

### Optionality

The Directive provides for optionality in implementation in that the Directive applies separately to pre-2010 VA Contracts and post-2009 VA Contracts, and there is optionality with respect to those two sets of contracts. In other words, a company can choose to implement the Directive method for pre-2010 VA contracts, for post-2009 VA Contracts or both. However, a company that implements the Directive for post-2009 VA Contracts also is required to apply it to any VM-20 life insurance contracts within its scope.

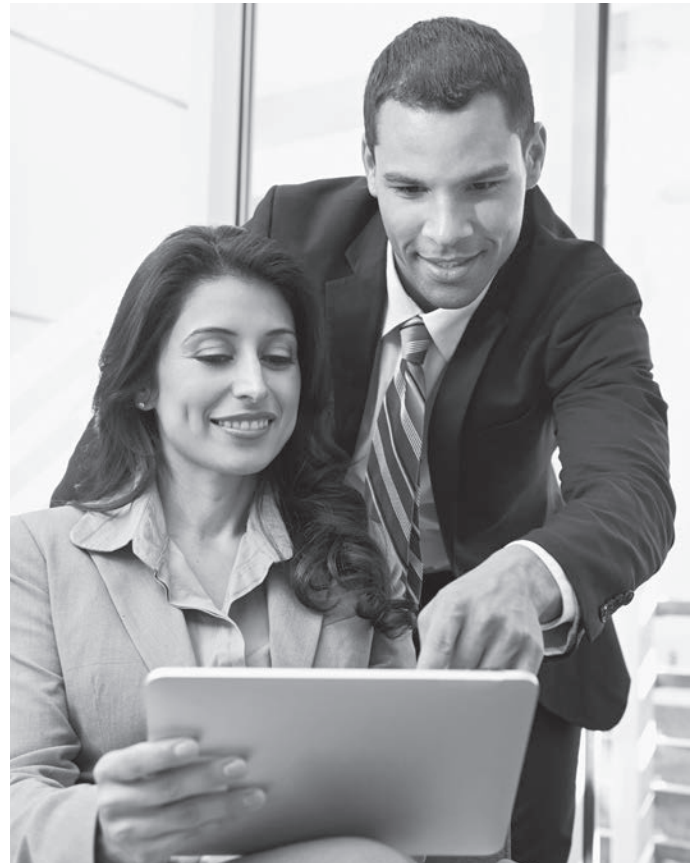
### Effect on Examinations

If a company implements the Directive, the IRS must stand down on examinations of the reserve issues covered by the Directive for the years 2010 through 2017. Likewise, by implementing the Directive, companies agree not to pursue refund

claims with respect to issues covered by the Directive. The IRS, however, is permitted to audit implementation of the Directive (*i.e.*, whether the company complied with the terms of the Directive), but only in connection with examination of the 2017 tax return. A company is considered to properly implement the Directive if it attempts in good faith to do so and subsequently and in good faith provides any necessary corrections or additional information. If the company does not implement the Directive, or only implements with respect to a portion of the Directive, regular audit procedures still apply to the portions not elected if the company comes under examination.

### Implementation for VA Contracts

For VA Contracts, implementation of the Directive depends on whether a 10-year spread is required. Generally, a 10-year spread is required unless no I.R.C. § 807(f) adjustment would have been required if the Directive method had hypothetically been adopted in the company's earliest open year as determined on a consolidated return basis. Another situation in which no 10-year spread is required is where the first year in which a statutory CTE Excess occurred is an open tax year. For this purpose, the earliest open year is determined by examining whether a hypothetical use of the tax reserve safe harbor would have resulted in a refund or deficiency for that tax year.



- **If no 10-year spread for a company is required,** the Directive provides the change for that company to be implemented on the 2017 tax return on a cumulative basis without spreading any amount to future tax years. Specifically, the company is required to compare the 2016 closing balance determined on the old method to the closing 2017 balance determined on the Directive method, and the entire change is to be reported on the 2017 tax return. As an example, if the company's earliest open year is 2013 and it had a statutory CTE Excess amount for the first time in that year, a change in basis of determining reserves would not have occurred in 2013 if it had reported on the Directive basis in that year. Thus, the company's adjustment to adopt the Directive method is to be implemented entirely in 2017, with no spread amount to future taxable years.
- **If a 10-year spread is required,** the company has two options for compliance with the Directive. The selected option is required to be applied consistently to all companies in a consolidated group.
  - **Option 1.** Under the first option, the company assumes that the change in basis of determining reserves occurs in 2016, and the company implements the change with a 10-year spread but including contracts issued in 2016 for purposes of the adjustment. Thus, the company determines the spread amount by comparing its closing 2016 reserves computed on the Directive method to its 2016 closing reserves computed on the old method and begins spreading this adjustment amount over the following 10 years starting in 2017. The beginning reserve for 2017 is based on the Directive method, and the change in reserves in 2017 is reported on the 2017 return. This method of implementation is required for companies that have an intervening closed year between the earliest open year and 2017 (such as where the IRS skipped examination years), if a 10-year spread would have been required had the method been adopted in the earliest open year. Otherwise, this option is likely to be adopted only where the Directive would result in tax reserve weakening and the company seeks audit protection.
  - **Option 2.** Under the second option, the company is required to determine a 10-year spread adjustment amount as if the change in basis of determining reserves occurs in the earliest open year and as if the 10-year spread amortization begins in the year following the earliest open year. The company then makes a cumulative true-up adjustment on its 2017 tax return as if the 10-year spread adjustment has been implemented based on a change in basis of determining reserves in the earliest open year. Any remaining spread amounts that would not have been

recognized under the hypothetical 10-year spread are recognized in 2018 and subsequent tax years.

For example, assume that a company's earliest open year is 2013 and its 10-year spread amount would have been \$50 to be recognized *pro rata* at \$5 per year starting in 2014 if the company implemented the Directive method in 2013. Under the Directive Option 2, the company would include in its 2017 true-up adjustment a cumulative 10-year spread amount of \$20 (for 2014, 2015, 2016 and 2017 at \$5 per year) and have a remaining amount of \$30 to spread over the years 2018 through 2023, at \$5 per year. Assume further that the company's 2017 opening balance under the old method is \$1,000 and its 2017 closing balance under the Directive method is \$1,200. The company's 2017 true-up adjustment (inclusive of the \$20 for the first four years of spread) is \$170 (*i.e.*, the \$200 change in balance minus the \$30 that remains to be spread in future years 2018 through 2023).

#### Implementation for pre-2010 VA Contracts With GMLBs

The same rules as described, at the company's option, apply to pre-2010 VA contracts. Although this may often result in a 10-year spread adjustment, such an adjustment likely would not apply if, for example, GMLB risks were assumed by reinsurance in an open year, or if tax reserves using both the old method and the Directive method would have been capped by statutory reserves in the earliest open year.

#### Implementation for Life Contracts

The implementation for life insurance contracts subject to VM-20 and that are reported under VM-20 on the annual statement is simply reported under the safe harbor method as of year-end 2017 on the 2017 tax return.

#### Processable Adjustments

If the Directive is adopted (for either post-2009 VA Contracts, pre-2010 VA Contracts with GMLB or both), the original tax return treatment of the tax reserves for the relevant type of contracts must be accepted by both LB&I auditors and companies. "Processable adjustments" can be made, however, which include carrybacks or carryovers triggered by adoption of the Directive, correction of mathematical and posting errors, adjustments necessary to conform closing tax reserves with opening tax reserves between years, and adjustments to reflect final administrative or judicial proceedings.

#### Certifications

The Directive requires detailed certifications that are signed under penalty of perjury by an officer of the company on a

company-by-company basis within the group. The certifications contain the details of the adjustments described and are required to be provided to the IRS within 30 days of a request by the IRS. Errors made in certifications prepared in good faith will not invalidate adoption of the Directive if appropriately corrected.

### TCJA Transition Adjustment

For companies implementing the Directive, the eight-year spread beginning in 2018 for the transition to tax reserves computed under the TCJA is to be computed by assuming that the Directive method was the proper tax return method as of year-end 2017. Further, the Directive requires any remaining 10-year spread resulting from adoption of the Directive to continue after 2017.

### CONCLUSION

There may be some winners and losers in the IIR process, given the fact that the Directive requires companies to implement its terms on the 2017 tax return regardless of a company's tax posture and does not permit any amendments to prior tax returns. However, by all indications, the IIR process accomplished what it was intended to—that is, resolution of complex industry-wide issues on a basis mutually acceptable to the IRS and a large portion of the industry and in a manner that saves great amounts of time and resources for both the government and the taxpayers.

In retrospect, the IIR process served another valuable function. It helped focus the industry and government personnel on the shortcomings of the then-current tax reserve rules and helped pave the way to a legislative response in the TCJA that made the issues addressed in the IIR moot for post-2017 tax years. ■

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### ENDNOTES

- 1 2016-13 I.R.B. 497.
- 2 *I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies*, LB&I-4-0712-009 (July 30, 2012). See also Arthur C. Schneider & Samuel A. Mitchell, IRS Utilizes the Industry Issue Resolution Program to Resolve the Insurance Industry Bad Debt Issue, *TAXING TIMES*, Vol. 9, Issue 1, at 20 (Feb. 2013).
- 3 *I.R.C. §446: LB&I Directive for Hedging of Variable Annuity Guaranteed Minimum Benefits (GMxB) by Insurance Companies*, LB&I-04-0514-0050 (July 17, 2014). See also Eric Bisighini & Tim Branch, Variable Annuity Hedging Directive—A Long and Winding Road, *TAXING TIMES*, Vol. 10, Issue 3, at 1 (Oct. 2014).
- 4 Pub. L. No. 115-97 § 13517; I.R.C. § 807(d). Pub. L. No. 115-97 is formally titled “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”
- 5 Specifically, the revised law provides that life insurance reserves are to be determined under CRVM/CARVM prescribed by the NAIC as of the date the reserve is determined and are deductible after a haircut of 7.19 percent, subject to a cap equal to the reserve reported on the annual statement. For variable contracts, the deductible reserve is equal to (1) the greater of the net surrender value or the reserve accounted for separately under I.R.C. § 817, plus (2) 92.81 percent of the excess of the reserve determined under CRVM (life)/CARVM (annuities) as prescribed by the NAIC on the date the reserve is determined, over the amount determined in (1), subject to a cap equal to the aggregate reserves for the contract reported on the annual statement. I.R.C. § 807(d).
- 6 See generally Kristin Norberg & Jeffrey Stabach, Changes to the Computation of Tax Reserves under P.L. 115-97, *TAXING TIMES*, Vol. 14, Issue 2, at 14 (June 2018).
- 7 As under prior law, certain reserves (e.g., deficiency reserves and reserves attributable to deferred and uncollected premiums not includible in premium income) remain completely nondeductible.
- 8 2010-15 I.R.B. 547.
- 9 Peter H. Winslow, Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves, *TAXING TIMES*, Vol. 12, Issue 1, at 21 (Mar. 2016).
- 10 Peter H. Winslow, VM-20 Deterministic Reserves in Federally Prescribed Reserves, *TAXING TIMES*, Vol. 12, Issue 2, at 26 (June 2016).
- 11 The IRS IIR team later expanded the scope of the project to cover VA Contracts with Guaranteed Living Benefits issued before 2010. See further discussion.
- 12 See generally Samuel A. Mitchell, Significant LB&I Examination Developments, *TAXING TIMES*, Vol. 12, Issue 3, at 28 (Oct. 2016).
- 13 Specifically, pre-2010 contracts are those with GMLBs that became subject to AG 43 for statutory accounting on December 31, 2009 (i.e., contracts with GMLBs that were issued on or after January 1, 1981, and before December 31, 2009).
- 14 The Directive does not apply to pre-2010 VA contracts without GMLBs or to tax years beginning before 2010.
- 15 The Directive does not require the adoption of VM-20 for tax purposes in 2017 if not adopted for statutory reserves.
- 16 Implementation of the Directive may sometimes be referred to as elective, though there is no election statement as such. The “election” is to be made by applying the Directive on the 2017 federal income tax return and providing the required certifications.



# ACLI Update

By Mandana Parsazad, Regina Rose and Jaclyn Walkins

**T**he end of 2018 brought with it several tax proposals and changes, impacting retirement, savings, business interest expenses and risk-based capital. Let's look at these further.

## RETIREMENT, SAVINGS AND OTHER TAX RELIEF ACT

On Nov. 26, 2018, House Ways & Means Chairman Kevin Brady released a tax and oversight package that includes the Retirement, Savings, and Other Tax Relief Act of 2018 and the Taxpayer First Act of 2018. The bill contains five titles: (1) Extension of Expiring Provisions, (2) Disaster Tax Relief, (3) Retirement and Savings, (4) American Innovation, and (5) Certain Tax Technical Corrections. It also contains the Taxpayer First Act of 2018, which proposes to redesign the Internal Revenue Service. On Nov. 28, the House Rules Committee adopted a Manager's Amendment, which clarifies that the scope of areas covered by the Disaster Tax Relief Title, and adds a sixth title on "Exempt Organizations," eliminating the increase in unrelated business taxable income related to certain transportation fringe benefits and modifying the rules related to business holdings of private foundations. On Nov. 29, the nonpartisan Joint Committee on Taxation released the estimated budget effect of the revenue provisions contained in the bill, determining the cost of the package to be about \$54 billion.

The title on "Certain Tax Technical Corrections" contains only five tax technical corrections provisions to the Tax Cuts and Jobs Act (TCJA) but notably includes a provision to clarify that remittances of tax in excess of the regular tax are not required to be applied to any remaining installments under section 965(h). Overpayments are not allowed to be credited to installments due under section 965(h) until the date on which the tax installment is due. Many companies, both life insurers as well as companies in other industries, have advocated for this correction to TCJA. The four other technical corrections provide clarifications to several items, including the cost recovery period for qualified improvement property, the effective date of net operating loss modifications in TCJA, non-deductibility of attorneys' fees in section 162(q), and application of the 20 percent deduction to REIT dividends in section 852(b).

Title I on "Extension of Expiring Provisions" makes limited extensions and key reforms of certain expiring tax provisions. Namely, it modifies and makes permanent the railroad track maintenance credit, extends and phases out the biodiesel and

renewable diesel credit, extends expiring trust fund taxes for 2019 only and generally extends other expiring tax provisions for 2018 only.

Title II on "Disaster Tax Relief" provides special rules allowing access to retirement funds; temporary suspension of limits on deductions for charitable contributions; allowance of deductions for personal casualty disaster losses; special rules for measurement of earned income for purposes of qualification for tax credits; and a special credit for employees to individuals and businesses affected by certain hurricanes, typhoons, California fires, Hawaii volcanic eruptions and earthquakes, and Hawaii severe storms, flooding, landslides, and mudslides. As noted, a Manager's Amendment clarified the scope of the areas covered and the applicability period for modifications with respect to section 403(b) plans in this regard.

Title III contains a number of important retirement and savings provisions, which life insurers have strongly supported: provisions expanding open Multiple Employer Plans (MEPs), lifetime income portability, a fix to the current annuity provider selection safe harbor, a lifetime income disclosure provision, and a repeal of the maximum age for IRA contributions. The bill includes the previously introduced House of Representatives Family Savings Act provision allowing for penalty free withdrawals from retirement plans in the case of birth of child or adoption but not its universal savings account provision.

Title IV on American Innovation would allow new businesses to write off more of their initial start-up costs and allows start-ups to expand without triggering limits on tax benefits, such as net operating losses and the R&D tax credit.

The Taxpayer First Act of 2018 modernizes the IRS and makes taxpayer service the focus of the agency by improving the ease and efficiency of the taxpayer experience when filing taxes, retrieving information, resolving issues and making payments. Notably, the bill codifies the requirement of an independent administrative appeals function at the IRS, ensures that staff working in the Independent Office of Appeals does not receive advice from the Office of Chief Counsel or from IRS employees working on the case prior to its referral for administrative review. Further, it provides taxpayers access to "the case against them," if requested.

The House of Representatives passed the Retirement, Savings, and Other Tax Relief Act late in the end of the 115th Congress and sent it to the Senate, where the bill did not receive any consideration.

## BUSINESS INTEREST EXPENSE DEDUCTION PROPOSED REGULATIONS

On Nov. 26, 2018, the IRS issued proposed regulations concerning the business interest expense deduction for certain taxpayers in TCJA.

The regulations state that, for tax years beginning after Dec. 31, 2017, the deduction for business interest expense is generally limited to the sum of a taxpayer’s business interest income, 30 percent of adjusted taxable income and floor plan financing interest. The regulations confirm the information contained in Notice 2018-28 that net interest will be calculated at the consolidated group level and that business interest income is inclusive of income earned on insurer’s portfolios. Wholly owned partnerships and members of an affiliated group that do not file a consolidated return would not be aggregated with the consolidated group for purposes of the limitation.

Business interest is defined broadly in the regulations, including loan commitment fees and swap payments made or received on interest-bearing assets or liabilities. In addition, the regulations indicate that investment interest, expenses or income that a partnership allocates to a C corporation partner would be recharacterized as interest, expenses or income allocable to a trade or business of the C corporation.

Taxpayers will use the new Form 8990, Limitation on Business Interest Expense Under Section 163(j), to calculate and report their deduction and the amount of disallowed business interest expense to carry forward to the next tax year.

This limit does not apply to taxpayers whose average annual gross receipts are \$25 million or less for the three prior tax years. This amount will be adjusted annually for inflation starting in 2019.

**RISK-BASED CAPITAL RESULTING FROM TAX REFORM**

All life insurance companies and fraternal benefit societies will be faced with a significant increase in risk-based capital (RBC) requirements resulting from tax reform, because RBC is designed as an after-tax calculation. As part of the changes made to reflect the impacts of tax reform, the NAIC Life RBC Working Group also made technical changes to the RBC components other than simply changing the tax rates from 35 percent to 21 percent, because that change alone would have caused RBC required capital to increase approximately 21.5 percent and would have decreased RBC ratios at companies by approximately 18 percent. Changes proposed by the American Academy of Actuaries as well as by the ACLI were adopted by the Life RBC Working Group on its June 8, 2018, conference call and by the NAIC Capital Adequacy Task Force on its June 28, 2018, conference call. The NAIC Executive Committee and Plenary accepted these changes by unanimous consent following the summer NAIC meeting in Boston.

The offsetting adjustments adopted by the NAIC moderated the impact of lowering the tax rates and generally increased RBC requirements 10 to 15 percent, depending upon the company. This translates into a reduction in RBC ratios from 9 to 13 percent.

To help ensure that the RBC changes would have minimal impact on companies’ ratings, the industry worked with Moody’s (the only rating agency that does not use its own required capital model) to explain the changes and what they mean for a well-capitalized company.

ACLI has requested that NAIC develop a document that describes the changes made to RBC as a result of the TCJA to assist state financial examiners and other state regulators with an explanation of why lower RBC ratios do not correlate with riskier companies. The NAIC tasked the American Academy of Actuaries with developing the first draft, which has been delivered to the Life RBC Working Group and was exposed for public comment. This will be a public document and should be able to be used by companies with other constituents who have questions about their lower RBC ratios. The finalized document should be available by year-end 2018.

The document will contain detailed information explaining why tax reform impacted Life RBC, how Total Adjusted Capital (TAC) is impacted, how Authorized Control Level (ACL) RBC changes as a result of the Life RBC formula, how the changes resulting from tax reform may cause more companies than normal to trigger the Life RBC Trend Test at Dec. 31, 2018, and how regulators and examiners should respond when the Life RBC Trend Test is triggered as a result of tax reform changes. The document will examine in detail the changes to ACL RBC, TAC and RBC results due to the TCJA. This includes why a reduction in tax rates cause an increase in ACL RBC, what changes in ACL RBC will be effective for the 2018 filing year, how TAC is affected by the TCJA, how effects of the TCJA should be factored into the interpretation of RBC results, and how elements of the TCJA will affect the components of the Life RBC calculation in the future. ■

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

## Proposed Regulations on Global Intangible Low-Taxed Income (GILTI)

By Meredith Blanding and Katarzyna Marchocka

On Sept. 13, 2018, the IRS released REG-104390-18, proposed regulations (the “Regs”) related to Section 951A, Global Intangible Low-Taxed Income (GILTI), which was enacted in 2017 as part of the Tax Cuts and Jobs Act (TCJA). The Regs provide guidance for U.S. shareholders in certain foreign corporations to determine the amount of GILTI to include in gross income (“GILTI inclusion amount”).<sup>1</sup> The Regs address the amount of GILTI inclusion and prescribe new pro rata share rules for determining a U.S. shareholder’s GILTI inclusion for purposes of Section 951A.<sup>2</sup> The Regs are generally effective for tax years beginning after Dec. 31, 2017. This article provides an overview of the Regs and highlights important open issues regarding determination of a U.S. shareholder’s GILTI amounts.

### BACKGROUND

TCJA created a new category of foreign income loosely derived from “intangibles” that generally cannot be deferred (GILTI income).<sup>3</sup> GILTI income is treated in a manner similar to subpart F income, which in general is foreign-generated income that is taxed to certain U.S. owners of a foreign business. GILTI seeks to include in U.S. taxable income the low-taxed income of a controlled foreign corporation (CFC) that is not otherwise treated as subpart F taxable income under another section of the Code and that exceeds a “routine” (10 percent) return on the U.S. tax basis in a CFC’s depreciable tangible assets.<sup>4</sup> GILTI is equal to the amount of a CFC’s “net tested income,” which exceeds the net deemed return on the foreign corporation’s tangible assets (based on a percentage of qualified business assets, or QBAI less interest expense).<sup>5</sup>

Eligible C corporations are entitled to a tax credit for 80 percent of foreign taxes paid by their CFCs attributable to the GILTI amount. The amount of foreign taxes attributable to the GILTI amount is calculated by multiplying the U.S. Shareholder’s “inclusion percentage” by the total foreign income taxes paid by

such CFCs that are attributable to tested income. The inclusion percentage is the ratio of such U.S. Shareholder’s GILTI amount divided by the relevant aggregate amount of tested income.

A deduction is available under section 250 for 50 percent of the GILTI inclusion inclusive of the “section 78 gross-up” on foreign taxes remitted.<sup>6</sup> At the new 21 percent corporate tax rates, this produces an effective tax rate of 10.5 percent on any GILTI inclusion (before taking into account any foreign tax credits). For tax years 2026 and later, the deduction is reduced to 37.5 percent of the GILTI inclusion plus any related Section 78 amount, producing an effective tax rate of 13.125 percent. The amount of the GILTI deduction is subject to limitation if the sum of such GILTI and foreign derived intangible income (FDII) exceeds its taxable income.

The Regs provide general rules and definitions around the calculation of tested income and loss, specified interest expense, treatment of domestic partnerships and their partners, and the treatment of the GILTI inclusion amount and adjustments to earnings and profits/basis. The Regs also include GILTI anti-avoidance rules. New reporting rules requiring the filing of Form 8992, U.S. Shareholder Calculation of GILTI, are also described in the Regs.

The Regs, however, do not address Section 250 and Section 960 (foreign tax credit). The Treasury announced that there will be additional regulations addressing these provisions.

### NET TESTED INCOME

Net tested income excludes income that would otherwise be subpart F income under other existing provisions of the Code or would be excluded from subpart F via the high-taxed income exception under Section 954(b)(4). Income that would have been exempt from subpart F either under the active finance or active insurance exceptions (AFE) in Sections 954(h) and (i) is **not** excluded from the definition of tested income for GILTI purposes. Generally, unlike the high-tax exception for Foreign Tax Credit (FTC), the high-tax exception exclusion from GILTI is likely not available to foreign insurers for insurance and investment income that is excluded from subpart F pursuant to the AFE.

### TESTED LOSS

Section 951A provides a coordination rule that is intended to deny a double benefit resulting from tested losses. Under that coordination rule, a tested loss CFC increases its earnings and profits by the amount of its tested loss for purposes of applying the subpart F current year earnings and profits limitation contained in Section 952(c)(1)(A) (the “tested loss add-back”). There is no indication that tested loss must offset tested income to be subject to this rule.

## CONSOLIDATED GROUPS: AGGREGATE BASIS AND PRO RATA SHARE ALLOCATION

Generally, the Regs require a consolidated approach for determining a consolidated group member's GILTI inclusion. In several steps, a consolidated group aggregates and allocates tested losses, QBAI and specified interest expense. First, each member determines its tested income on a stand-alone basis. Then, the "GILTI allocation ratio" is determined based on each member's pro rata share of the total tested income of the consolidated group. Finally, shares of the consolidated group's total tested losses, QBAI and specified interest expense are allocated based on the "GILTI allocation ratio."

## ANTI-AVOIDANCE PROVISIONS

The Regs provide a set of anti-abuse provisions. First, a "facts and circumstances" approach is required for allocating subpart F and GILTI income. Second, all transactions or arrangements that were undertaken with a principal purpose of reducing subpart F or GILTI inclusions may be disregarded. Third, there are two QBAI-specific anti-abuse measures:

- Specified tangible property is disregarded in computing a CFC's QBAI if the CFC (1) acquires the property with the principal purpose of reducing GILTI inclusion and (2) holds the property temporarily and as of at least one quarter-end. Property held for a less-than-12-month period that includes at least one quarter-end is treated as temporarily held and acquired with the requisite avoidance purpose.
- The Regs deny the benefit of stepped-up basis in specified tangible property transferred between related CFCs during the period before the transferor CFC's first GILTI inclusion year. As such, the transferee CFC's QBAI is computed without the increased basis—generally leading to a lower return on tangible property and, thus, a larger GILTI inclusion.

## SOME OPEN ISSUES

While the Regs offer helpful guidance, the new law is very complex and there are some areas where taxpayers may still have questions or seek additional clarifications. The interplay between GILTI and the foreign tax credit provisions is complex, and taxpayers will appreciate further clarifications of that issue in subsequent guidance. GILTI income, for example, is in its own "basket" for foreign tax credit limitation purposes.

"Taxable income" for these purposes is computed after the net operating loss (NOL) deduction under Section 172. The NOL deduction is computed based on taxable income without regard to the Section 250 deduction mentioned previously. Taxpayers have been asking questions around the interpretation of the "without regard to" language in the above-mentioned provision.

Does the NOL computation ignore just the current year Section 250 deduction? Or would it exclude a cumulative deduction for prior years as well in an NOL carryforward scenario?

## TAKEAWAY

The Regs provide a start for taxpayers to interpret and apply the new GILTI provision. Yet, in the absence of completed IRS guidance, taxpayers still face uncertainty (and possibly opportunity). Taxpayers await clarification on multiple issues, many of which have been raised in comments submitted to the Treasury. Certainly, there is more to come on the GILTI front. Modeling exercise might be necessary in order to estimate the implications of GILTI/FTC/Subpart F interactions. ■

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## ENDNOTES

- 1 A U.S. shareholder for these purposes is a domestic corporation that owns directly or indirectly 10 percent or more of the stock (by vote or value) of the foreign corporation.
- 2 Unless otherwise specified, all "Section" and "\$" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder, all as in effect (or, in the case of proposed regulations, as proposed) as of the date of this article.
- 3 TCJA introduced a new category of income called GILTI under new Section 951A. The GILTI provision is effective for tax years beginning on or after Jan. 1, 2018.
- 4 A CFC is any foreign corporation of which U.S. shareholders own more than 50 percent of the vote or value. The required percentage U.S. ownership for CFC status is reduced to 25 percent if the foreign corporation is an insurance company.
- 5 A CFC's QBAI for a tax year means the average of its aggregate adjusted bases (for U.S. federal income tax purposes, as measured as of the close of each quarter of the tax year) in "specified tangible property" used by the CFC in a trade or business and for which a deduction is allowable under Section 167. "Specified tangible property" generally means any tangible property "used in the production of tested income." Tangible property used by a CFC in the production of tested income and income that is not tested income is treated as specified tangible property in the same proportion as the tested income produced "with respect to" the property bears to the total gross income produced "with respect to" the property. The adjusted basis in any property is determined by using the alternative depreciation system under Section 168(g) and by allocating the depreciation deduction ratably to each day during the period in the tax year to which the depreciation relates.
- 6 "Section 78 gross-up" requires that if a deemed paid foreign credit is claimed, the amount equal to the taxes deemed to have been paid must be included in the gross income of the domestic corporation. This gross-up income is treated as if it were a foreign dividend received by a domestic corporation.

# IRS's Proposed LRD Rules for Nonlife Reserves are Out

By Jay Riback

*Editor's note: Subsequent to TAXING TIMES' editorial deadline, the IRS released Rev. Proc. 2019-06, which provided proposed discount factors under § 846 for tax years 2017 and 2018. In addition to providing the factors, Rev. Proc. 2019-06 indicated that the IRS and Treasury may publish revised discount factors following the promulgation of final regulations. TAXING TIMES will address Rev. Proc. 2019-06, revised discount factors and other developments in loss reserve discounting following the release of final regulations later in 2019.*

On Nov. 5, 2018, the Internal Revenue Service (the IRS) released REG-103163-18, proposed regulations for Modification of Discounting Rules for Insurance Companies (“the Regs”). The Regs primarily concern loss reserve discounting (LRD) for property-casualty (P&C) unpaid losses under I.R.C. section 846<sup>1</sup> and were promulgated in response to changes in the LRD rules under the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA or “the Act”).<sup>2</sup>

While the Regs provide insights on a variety of issues, they still leave a number of questions unanswered. This article sets forth the LRD rules as revised by the TCJA, analyzes the major changes proposed in the Regs, and highlights some remaining unknowns that remain to be addressed even as companies implement the TCJA for tax year 2018.

## BACKGROUND

While unpaid losses continue to be discounted by accident year (AY) and line of business (LOB) using an applicable interest rate and loss payment patterns as inputs under the TCJA, the Act made significant changes to how those inputs would be determined.

The interest rate used to calculate LRD was historically based off a single rate, the 60-month average market yield of Treasury bonds with maturities of more than three years but not more than nine years.<sup>3</sup> The TCJA bases the rate on the corporate bond yield curve with maturities to be determined by Treasury.<sup>4</sup>

Under both old law and the TCJA, loss payment patterns for all companies are determined by the Secretary of the Treasury based on the aggregate payment experience reported by insurers on their annual statements, redetermined every fifth year (i.e., in each “determination year.”)<sup>5</sup> Insurers were historically permitted to substitute their loss payment experience for the aggregate patterns, but this election was repealed under the TCJA.<sup>6</sup> Short-tail lines of business are required to be discounted over a three-year period under both current and former law.<sup>7</sup>

Historically, loss reserves for long-tail lines of business were required to be discounted up to 15 years.<sup>8</sup> However, supplemental IRS guidance allowed taxpayers to limit their discount to the 10 accident years disclosed in the Annual Statement, applying a “composite” discount factor for that tenth year.<sup>9</sup> Under the TCJA, taxpayers are required to average the payment patterns for years seven to nine and then apply that average payout pattern for years 10 to 24, as applicable.<sup>10</sup>

While non-proportional reinsurance and international lines of business are presented in a similar fashion to other long-tail LOBs in the annual statement, they were carved out of the definition of long-tail lines in the Code.<sup>11</sup> Ultimately, they were discounted similar to other long-tail lines under relevant regulations.<sup>12</sup> As the Code section governing international and non-proportional reinsurance lines was repealed under the TCJA, these LOBs would seemingly be discounted as short-tail lines on a go-forward basis.<sup>13</sup>

Companies are also required to discount salvage and subrogation (S&S) receivable based on either unique S&S discount factors published by the IRS or the loss reserve payment patterns determined under I.R.C. section 846.<sup>14</sup> Historically, the IRS has published separate S&S factors rather than relying on loss payment patterns.<sup>15</sup>

## CHANGES PROPOSED UNDER THE REGS

The Regs contain four primary components:

- Changes to the applicable rate of interest to be used in the LRD calculation under I.R.C. section 846(c)(2);
- Changes to the computation of loss payment patterns in the LRD calculation under I.R.C. section 846(d);
- Repeal of the composite method originally permitted under Notice 88-100 as an acceptable method for long-tail lines of business; and
- Elimination of distinct discount factors for S&S under I.R.C. section 832.

## The Applicable Rate of Interest

One of the most prominent items of speculation following the passage of the TCJA (including in this publication)<sup>16</sup> was how the new applicable rate of interest would be determined using the corporate bond yield curve. The Regs continue the use of a single interest rate but considerably expand the range of maturities on the bonds that would feed into the rate to include the average of rates “with times to maturity of not more than seventeen and one-half years.”<sup>17</sup> The choice of maturity range was unanticipated by many in industry, as it represents a near-doubling of the maturity ceiling while also extending the range beyond the majority of even the longest-tailed P&C reserves.

The preamble indicates that the decision to substitute the corporate bond yield curve for Treasury rates manifests an intent that, “the annual rate should be determined in a manner that more closely matches the investments in bonds used to fund the undiscounted losses to be incurred in the future . . .”<sup>18</sup> In furtherance of this goal, the IRS considered a multi-rate approach wherein the bond maturity for each payment pattern would match the spread between the year of loss and year of payment, which would best reflect the time value of money impact of bonds backstopping said reserves. However, the preamble also notes that the language of the TCJA did not demonstrate clear statutory intent to change from a single rate to a multi-rate regime. To reconcile these priorities, the IRS selected a single-rate maturity range, which “minimize[d] the differences in taxable income, in the aggregate, resulting from the use of a single discount rate versus” the income that would have been generated under the aforementioned multi-rate approach.<sup>19</sup>

## Loss Payment Patterns

The preamble notes that the occurrence of negative loss payment patterns in certain periods “produce discount factors that vary widely from year to year or discount factors that are negative or that exceed one.”<sup>20</sup> The IRS requested taxpayer comments on this issue in Rev. Proc. 2003-17, and commenters expressed a desire for the IRS to adopt a “smoothing” mechanism to minimize such distortions. Ultimately, the IRS declined to implement the smoothing mechanism in the ensuing determination year.<sup>21</sup> In an effort to address this lingering issue, the preamble to the Regs provides an example of a seven-step method to smooth payment patterns in the event that the pattern is negative in a given year. While the precise mechanics of the method are relatively complicated, the primary mechanism for smoothing is to average the negative payment pattern year with adjacent periods until a positive average is attained.

While the IRS considered a number of other methods for dealing with this issue, the preamble indicates it opted for

the seven-step method as it reduces bias toward the changing of non-negative factors and it best preserves the AY seven to nine average payment pattern, which is applied in AYs 10 and onward.<sup>22</sup> We note this method is not memorialized in the text of the regulations; rather, a broad grant of discretion is afforded for the secretary to develop a smoothing mechanism on the basis of the example provided.<sup>23</sup>

## The Composite Method

The original guidance providing for the composite method, Notice 88-100, indicated that formal regulatory guidance would prevent the discounting of loss years not separately disclosed in the annual statement. While that guidance was never finalized, the IRS continued allowing companies to use the composite method to discount all reserves in the 10th year and beyond with a single composite factor. The Regs would eliminate such a composite factor, providing that “a taxpayer that has unpaid losses relating to an accident year not separately reported on the NAIC annual statement must compute undiscounted losses with respect to that year using the discount factor published by the Secretary for that year.”<sup>24</sup> The IRS likely will provide an automatic method change for companies that have been applying the composite method to switch to the newly prescribed method.

Repeal of the composite method represents a shift to a more literal interpretation of the text of the Code. The switch to a true discrete methodology is likely to generate additional administrative complexity and larger reserve haircuts for taxpayers with longer-tailed lines of business.

## Salvage and Subrogation

As noted, the IRS has latitude to discount S&S recoverable based on either salvage recovery patterns or loss payment patterns. In a reversal from existing practice, the Regs propose that the IRS cease issuing separate S&S factors and instead discount S&S based on the general loss reserve discount factors. Such a change would allow companies to net their gross loss reserves and S&S before applying a single discount factor to the net reserve balance, thereby reducing compliance cost and complexity. The preamble does not indicate whether the payment and losses incurred data used to calculate payment patterns should be considered gross or net of S&S.

## UNANSWERED QUESTIONS AND NEXT STEPS

The Regs offered insights on a number of pressing issues but also left several key issues unresolved. Most noticeably, there is some ambiguity as to what inputs should be used to calculate opening discounted loss reserves for purposes of the transition calculation. The transition rule provides that opening reserves

(i.e., 1/1/2018 reserves for calendar year taxpayers) “shall be determined as if the amendments made by this section had applied . . . and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018.”<sup>25</sup> Under one reading of the transition rules, the discount factors determined as of Dec. 31, 2018, would be applied to the opening reserves and discounted accordingly. Conversely, the rules could be interpreted to require the recalculation of prior year factors as if the TCJA had been in effect during such loss years and then applying those factors to the opening reserve balances.

Other unanswered questions include how discounted unpaid losses for international and non-proportional lines of business will be calculated and whether S&S recovery patterns will be included in revised loss reserve payment pattern calculations.

In advance of the Dec. 20, 2018, hearing on the Regs, the IRS requested public comments on the following items:

- Length of loss payment patterns to be used for discounting the international and non-proportional reinsurance lines of business;
- The methodology used to select the revised maturity window for the LRD interest rate; and
- Whether net payment data (loss payments less salvage recovered) and net losses incurred data (losses incurred less salvage recoverable) should be used to compute discount factors.

Some notable themes in the comments submitted to the IRS in response to the request for comments are as follows:

- **Interest rate.** Commenters seemed to unanimously disagree with the bond maturity range outlined in the Regs. Though many issues were raised, the most common was that the maturity range selected did not appropriately match the bonds held to backstop P&C loss reserves, resulting in an unduly high interest rate.
- **Composite method.** Commenters generally opposed repeal of the composite method, citing challenges obtaining older historical data, particularly for companies relying on “legacy technology” systems.
- **International and reinsurance LOBs.** Commenters remarked that Treasury lacked statutory authority to continue treating these LOBs as long-tail as a result of the changes made by the TCJA. At least one commenter suggested a technical correction would be required to restore prior treatment.

- **Smoothing adjustments.** Commenters generally supported the implementation of a smoothing mechanism to help produce a stable pattern of positive factors.
- **S&S discount factors.** Commenters generally supported applying the LRD factors to S&S balances as a simplifying measure.

While the Regs provided some clarity as to the IRS’s current thinking and the general direction for how some open questions will likely be resolved, they also left taxpayers eagerly awaiting final guidance to provide an ultimate resolution to LRD issues. ■

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#### ENDNOTES

- 1 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended through the date of this writing.
- 2 “An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97, enacted Dec. 22, 2017.
- 3 See former I.R.C. section 846(c)(2) and former I.R.C. section 1274(d).
- 4 See current I.R.C. section 846(c)(2).
- 5 See current and former I.R.C. section 846(d).
- 6 See former I.R.C. section 846(e).
- 7 See current and former I.R.C. section 846(d)(3)(A)(i).
- 8 See former I.R.C. section 846(d)(3).
- 9 IRS Notice 88-100, 1988-2 C.B. 439.
- 10 See current I.R.C. section 846(d)(3)(B)(ii).
- 11 See former I.R.C. section 846(d)(3)(E).
- 12 See Treas. Reg. § 1.846-1(b)(3), and Treas. Reg. § 1.846-1(b)(4).
- 13 TCJA Section 13523(b).
- 14 Treas. Reg. § 1.832-4.
- 15 See e.g., Rev. Proc. 2018-13, 2018-7 IRB 356.
- 16 Kristen Norberg, “Discounted Unpaid Losses: A Rate or a Curve?,” *TAXING TIMES* Vol. 14, Issue 2 (June 2018) at page 26.
- 17 Prop. Reg. § 1.846-1.
- 18 Modification of Discounting Rules for Insurance Companies, 83 Fed. Reg. 55650 (proposed Nov. 7, 2018).
- 19 *Id.*
- 20 *Id.* at 55651.
- 21 Rev. Proc. 2008-10.
- 22 Modification of Discounting Rules for Insurance Companies, *supra*, at 55652.
- 23 Prop. Reg. § 1.846-1(d)(2).
- 24 Modification of Discounting Rules for Insurance Companies, *supra*, at 55652.
- 25 TCJA Section 13523(e).



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