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Volume 63 ....Number 1
Complete Table Of Contents ....Page 1
Index To Current Cases 64

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Making the protective carryover basis election under the Sec. 338 Temp. Regs.
by Sheldon M. Bonovitz 10

Final Regs. implement limited exceptions to substantial understatement penalty
by Stephen C. Struntz and Nathan Braverman 2

Farm financing and operations require attention to DRA's many new provisions
by Lorence L. Bravenec and Clark S. Willingham 28

Tax forms for international transactions: filing guide for practitioners
by Richard G. Fishman.........................38

Preparing for asset reversions on termination of defined-benefit plan
by David B. Tatge................................20

When will a transfer to a partnership be treated as a sale under Sec. 707?
by Douglas J. Antonio..........................32

DRA introduces new concepts in taxation of life insurance companies
by M. Kovey, P. Winslow, S. Hooe.......48

Statement to agent can be an amended return...................... 7

Anti-takeover expenses are deductible says IRS.......................16

Estimated taxes clarified for FSC, other corps...........................16

Terminated plan distribution qualifies as "lump-sum".......................26

Partnership gets stepped-up basis without election.........................37

No correlative 482 adjustment on blocked income............................54

Allocation of pension plan assets............................55

Substantiation repealed but car benefits cut...........................56

No depreciation, ITC, where condo offered but not rented.....................60

Tax-free exchange problem corrected.............................63

July 1985

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PROBLEMS ARISING FROM

Special tax treatment

OF PARTICULAR INDUSTRIES

RICHARD G. FREIDIN, J.D., CPA

DRA introduces new concepts in altering taxation of life insurance companies

by **MARK H. KOVEY, PETER H. WINSLOW** *and* **STEPHEN D. HOOE**

The new law's add-on tax on the portion of a mutual company's income attributable to its policyholders' equity is a radical departure from traditional income tax concepts. In this second part of a two-part article, the authors analyze how the new tax affects life insurers.

IN ENACTING THE life insurance provisions of the Deficit Reduction Act of 1984 (the 1984 Act), Congress' greatest concern was to establish a taxing scheme that would reflect the fundamental difference between mutual and stock life insurance companies and provide a "level playing field" between them. The basic problem is that distributions by mutuals to their policyholders contain two components: a return on equity similar to a dividend to shareholders and a distribution to the policyholders in their capacity as customers.

The 1984 Act reflects a policy decision that all distributions to policyholders in their capacity as customers should be fully deductible by both stocks and mutuals. Because a shareholder dividend is taxable to shareholders and is not deductible by a stock company, however, Congress determined that mutuals should not be allowed to use the deduction for policyholder dividends, etc., to reduce their tax base below an amount representing an imputed return on the mutuals' equity. Congress assumed that both stocks and mutuals distribute earnings in amounts proportional to their owners' equity interest. The difference between the average post-dividend, pre-tax returns of stocks and mutuals, therefore, was determined to be attributable to distributions by mutuals of earnings to policyholders in their capacity as owners and to be the proper measure of the minimum portion of the mutuals' earnings that should be subject to tax at the corporate level.[1]

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Differential earnings amount

Sections 808 and 809, in effect, impose an "add-on" tax on the portion of a mutual company's income allocable to its policyholders' equity interest, *i.e.*, the amount distributable to policyholders in their capacity as owners. This add-on tax is implemented by a dollar-for-dollar reduction of the mutual company's deduction for policyholder dividends by the "differential earnings amount" (DEA). If the DEA exceeds policyholder dividends, the excess serves to reduce the deduction for the net increase in reserves under Section 807.

The DEA is the product of an individual mutual company's "average equity base" and the industry-wide "differential earnings rate." The latter is a percentage reflecting the excess of an imputed return on equity (indexed to the earnings of stocks) over mutuals' return on equity. This percentage is set at 7.8% for 1984 to result in mutuals bearing 55% of the aggregate industry tax for that year.

For years after 1984, the excess of the stock companies' "imputed earnings rate" over the "average mutual company earnings rate" is determined annually. In order that mutuals continue to bear 55% of the industry tax, the imputed earnings rate is indexed to a "plug" 16.5% figure.[2] That is, the imputed earnings rate is the amount that bears the same ratio to 16.5% as the numerical average of the rates of return for the 50 largest stocks for the three calendar years preceding the calendar year in which the taxable year begins (the "current stock earnings rate") bears to the numerical average of the rates of return for the 50 largest stocks for 1981, 1982, and 1983 (the "base period stock earnings rate"). For this purpose, all stock life insurance companies that are members of the same affiliated group are treated as one stock life insurance company.[3]

The average mutual company earnings rate is the weighted average earnings rate for all mutual companies for the second calendar year preceding the taxable year.[4] This two-year "look-back" rule is adopted to give Treasury sufficient time to determine the average mutual earnings rate to be used in the current year. A consequence of using the rate for the second preceding year is that the differential earnings rate may not accurately reflect mutuals' actual return on equity for the current year. To correct for the use of the earlier rate, Section 809(f) requires that the DEA be recomputed in the following year using the average mutual earnings rate for the current year. Any difference between the recomputed amount and the DEA as originally computed is taken into account as additional income or a deduction in the succeeding year.[5]

Once the differential earnings rate is determined, it is multiplied by the average of the mutual's equity base as of the end of the current and preceding taxable years. The "equity base" is an amount (determined in the manner prescribed by Regulations) equal to the company's capital and surplus, increased by the following adjustments:

1. Nonadmitted financial assets (not including due and accrued investment income, office furnishings, or agents' balances due the company).
2. The excess of NAIC Annual Statement reserves (not including any portion attributable to net deferred and uncollected premiums) over tax reserves.
3. The amount of certain other reserves, which include the mandatory securities valuation reserve, deficiency reserves, and any other voluntary reserve or similar liability.[6]
4. Fifty percent of the reserve for policyholder dividends or other similar liability (including reserves for experience rated refunds and excess interest) payable in the following year.[7]

The amounts included in the equity base are the items and values shown on the company's Annual Statement. An erroneous characterization in an attempt to

avoid inclusion in the equity base, however, will be disregarded.[8]

Stock life insurance subsidiaries of mutuals create a unique problem because they can operate like stocks and pay out shareholder dividends to the mutual parent, or they can operate like mutuals and pay out their profits in policyholder dividends to their customers. The legislative solution is to tax a stock life subsidiary as a stock company not subject to the add-on tax. In the case of an affiliated group with a mutual life company as the common parent, however, the capital and surplus of the stock subsidiary is included in the parent's average equity base (*i.e.*, the parent and subsidiary are treated as though they were one mutual life insurance company and the stock in the subsidiary is not treated as an asset owned by the parent). These rules apply only in the case of a life insurance subsidiary. In the case of a nonlife (insurance or noninsurance) subsidiary, the parent's equity base includes the subsidiary's stock (valued as in the parent's Annual Statement) and the earnings of the nonlife subsidiary are taken into account by the parent only when dividends are received.

The rules relating to stock life subsidiaries cannot be avoided by two or more mutuals jointly owning the subsidiary's stock. Section 809(h)(3) grants Treasury the authority to issue Regulations that require that proper adjustments be made in the average equity bases of the mutual owners as may be appropriate.

To alleviate the impact of the DEA on mutuals that have more surplus in relation to their assets than do mutuals generally, a special transitional rule under Section 809(i) reduces the DEA that a high surplus mutual otherwise would be required to take into account, *i.e.*, no DEA is computed with respect to the "excess" portion of the company's equity base.[9] The amount of any excess equity not taken into account will decrease ratably each year until 1989, when the entire equity base will be taken into account.

The add-on tax provisions are a radical departure from traditional income tax concepts in that a mutual's tax partially depends on the earnings of other unrelated companies, both stocks and mutuals. For example, if a few major mutuals engage in transactions that reduce their statement gain from operations, an increase in the differential earnings rate will result for the entire mutual segment of the industry. This, in turn, will cause an increase in the taxable income of all mutuals, not just those that actually reduced their statement gain from operations. Also, if the earnings of the 50 largest stocks taken into account in computing the imputed earnings rate during the 1981-1983 base period are lower than was assumed for purposes of the 55/45 allocation, this will increase the differential earnings rate and the overall tax burden of mutuals. As this "coupling" with stocks and "socialization" with other mutuals develops, these provisions undoubtedly will be controversial and subject to reexamination.[10]

Policyholder dividends

Under prior law, the classification of an item as a policyholder dividend was critical because of the deduction limitation measured by taxable investment income under former Section 809(f). While the 1984 Act eliminates the deduction limitation,[11] the distinction between policyholder dividends and other amounts continues to be relevant for limited purposes. For example: (1) for purposes of the mutual add-on tax, statutory surplus is increased by 50% of the company's provision for unpaid policyholder dividends payable in the following year; (2) policyholder dividends are one of the deduction items that must be allocated pro rata to all sources of income under Section 818(f) for purposes of computing the foreign tax credit limitation; and (3) the gross investment income portion of policyholder dividends is included in the policyholders' share of net investment income in determining the proration formula for tax-exempt interest and intercorporate dividends.

Under Section 808, the definition of policyholder dividends is expanded to include:

1. Any amount paid or credited (including any increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management.
2. Any excess interest, which refers to amounts in the nature of interest credited to the policyholder in excess of the prevailing state assumed rate in computing reserves (rather than in excess of the minimum rate guaranteed in the contract).
3. Any premium adjustments, which include any reduction in premiums otherwise due under the contract.[12]
4. Any experience rated refunds under group contracts, whether or not the company's retention formula is contractually fixed.

This broader definition of policyholder dividends essentially adopts the position of the Service under prior law.[13] Any policyholder dividend that increases the benefits payable under the contract (in-

[1] H. Rep't No. 98-432 (Part 2), 98th Cong., 2d Sess. 1422 (1984); S. Rep't No. 98-169, 98th Cong., 2d Sess. 548-549 (1984); Joint Committee on Taxation Staff, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (hereinafter referred to as "General Explanation") 612 (12/31/84).

[2] But, the 55/45 allocation of the industry tax burden will change automatically if the relative earnings of each segment of the industry change in the future. For example, if the mutual segment of the industry shrinks in subsequent years through demutualizations or otherwise, the remaining mutuals will not bear 55% of the industry tax.

[3] Section 1504(a), as amended by the 1984 Act, defines the term "affiliated group" for all purposes of Subtitle A of the Code and requires that the common parent own directly at least 80% of the total voting power of the stock of at least one other includable corporation. In addition, the value of the stock owned must represent at least 80% of the total value of the qualifying stock of the subsidiary. Other includable corporations are included if the 80% voting control and the 80% value tests are met by one or more other includable members of the group.

[4] For purposes of computing the imputed earnings rate and the average mutual earnings rate under Sections 809(d) and (e), Section 809(h)(1) treats a stock company as a mutual company if stock possessing at least 80% of the total combined voting power or total value of all classes of stock is owned at any time during the calendar year by one or more mutual companies.

[5] Because any addition to or deduction from income is taken into account in the first year during which the actual differential earning rate can be recomputed, no tax deficiency is created and no interest payment is required. H. Rep't No. 98-432, *supra* note 1 at 1425; S. Rep't No. 98-169, *supra* note 1 at 552, *General Explanation* at 617.

[6] Voluntary reserves are not limited to reserves for potential or unaccrued liabilities relating to insurance contracts. For example, a reserve for Federal income taxes may be in whole or in part a voluntary reserve. If the reserve is for a tax liability that might arise in the future if certain items are identified on audit, such a reserve is treated as a voluntary reserve because liability for those amounts is contingent on detection of the tax issue, assertion of a deficiency, and resolution of the issue. If the reserve is for taxes accrued and payable on the due date of the return for the year, it is not a voluntary reserve. It is anticipated that the Regulations will provide further guidance on whether a reserve is voluntary. *General Explanation* at 616.

[7] The inclusion in the equity base of only 50% of the total amount set aside on the Annual Statement for policyholder dividends reflects Congress's belief that, on average, only 50% of the total Annual Statement provision for policyholder dividends to be paid in the following year (whether accrued or unaccrued for tax purposes at the end of the year) is fairly allocable to the current year. Although a policyholder dividend may be paid at the end of a policy year, and not accrue until payment, recognition of part of that dividend as a current liability to determine the equity of the company reflects a determination that the dividend, in theory, accrued to policyholders in a financial sense over the entire policy year. *General Explanation* at 616-617.

[8] For example, the legislative history states that if a company sets up a provision on its Annual Statement for excess interest distributable in the following taxable year, and this provision is separate from its provision for unpaid policyholder dividends and is not adjusted for in restating Annual Statement reserves to tax reserves, then the provision will be treated as an "other similar liability" 50% of which is added to the equity base. H. Rep't No. 98-432, *supra* note 1 at 1424; S. Rep't No. 98-169, *supra* note 1 at 551; *General Explanation* at 617.

cluding cash value), or reduces the premiums otherwise required to be paid under the contract, is treated under Section 808(e) as if paid to the policyholder and returned by the policyholder to the company as an additional premium.

Unlike former Section 811(b), policyholder dividends are deductible under Section 808(c) only if they are paid or accrued during the taxable year.[14] This change from a reserve method of policyholder dividend accounting generally will result in a deferral of the dividend deduction to the taxable year in which payment is made, at least in those cases where the policyholder does not have a fixed right to a dividend until such date.

A difficult accounting issue is the determination when an unpaid liability for group experience-rated refunds accrues with regard to a closed policy year. The insurance company has rendered full economic performance within the meaning of Section 461(h) by providing insurance coverage for the expired term of the policy. This should be so whether or not all the claims arising under the policy have been paid. Nevertheless, in some cases the Service may take the position that the amount of the insurer's liability cannot be determined with reasonable accuracy as of year end and, therefore, its deduction must be deferred.[15]

The change to an accrual method for the policyholder dividends deduction is not treated as a change in accounting methods by virtue of the "fresh start" rule in Section 216(b) of the 1984 Act. Accordingly, there will be no Section 481 income adjustment attributable to the policyholder dividends that were deducted in 1983 under prior law's reserve method, and then deducted a second time in 1984 under accrual principles.

For companies willing to alter their business practices to accelerate accrual of policyholder dividends for policies with anniversary dates in the succeeding year, the 1984 Act's change in the accounting for policyholder dividends created a tax planning opportunity. For example, by guaranteeing payment of policyholder dividends or by making such dividends available upon declaration, a company could have obtained a one-time deduction of approximately 150% of one year's policyholder dividends. That is, it could have deducted those dividends that accrued for policy years terminating during the year *plus* policyholder dividends that accrued through year-end on open policy years as a result of the change in business practices. The technical corrections bill would eliminate this planning opportunity by providing for a reduction in the policyholder dividends deduction by the amount for which accrual was accelerated.[16]

Dividends/tax-exempt interest

The 1984 Act continues the prohibition against a life insurance company excluding or deducting from income the portion of tax-exempt income and the dividends-received deduction allocable to policyholders. "Proration" of these two items, however, is accomplished by different means. A company initially excludes tax-exempt interest from gross income, but then is required under Section 807 to reduce its deduction for reserve increases (or to increase its income from any reserve decreases) by the "policyholders' share" of any tax-exempt interest.[17] As to the dividends-received deduction, Section 805(a)(4) permits the company to deduct only the "company's share."

Proration does not apply to a "100% dividend," which is defined in Section 805(a)(4)(C) to include a dividend eligible for the 100% dividends-received deduction under Section 243 or 244 (but not Section 245(b)). These dividends are fully deductible except to the extent they are distributed out of tax-exempt interest or dividends received by the subsidiary that would not be eligible for the 100% dividends-received deduction if received directly by the parent.[18]

The income sources of dividends are determined by examining the subsidiary's earnings and profits history. A distribution is considered first to be made out of the most recent year's earnings and profits, and to be ratably funded out of tax-exempt interest, dividends other than 100% dividends, and all other items that contribute to that year's earnings and profits. Any dividends out of earnings and profits accumulated prior to 1984 are not considered to be funded with tax-exempt interest or dividends other than 100% dividends. By requiring that records be kept with regard to a company's current, accumulated, and pre-1984 earnings and profits, the 1984 Act's proration rules impose significant new administrative burdens.

Under the proration rules, the company's share of the prorated items is the percentage obtained by dividing the company's share of net investment income by the total net investment income for the taxable year.[19] "Net investment income" is now defined simply as 90% of "gross investment income."[20] Thus, prior law

[9] A company is a high-surplus mutual company if its equity percentage, *i.e.*, the amount of its average equity base expressed as a percentage of its average assets, exceeds 14.5% for taxable years beginning in 1984. The "excess equity base" is the excess of the average equity base over the amount that would be the average equity base if the equity percentage equaled 14.5% in 1984, 14% in 1985 and 1986, and 13.5% in 1987 and 1988. The excess equity base for any year, however, cannot exceed the excess equity base for 1984. H. Rep't No. 98-432, *supra* note 1 at 1425; S. Rep't No. 98-169, *supra* note 1 at 552-553; *General Explanation* at 618-619.

[10] Treasury is instructed to conduct a study of the effects of the 1984 Act, including an analysis of the relative shares of life insurance company taxes paid by stocks and mutuals. One immediate problem is the burden on the 50 largest stocks to recalculate reserves, etc., for 1981-83 solely to implement this provision.

[11] Although the 1984 Act nominally continues to limit the deductibility of policyholder dividends (explained above), the economic effect of the new provisions is to impose an "add-on" tax on the portion of a mutual company's imputed earnings allocable to its policyholders' equity interest. For example, even if a mutual pays no dividends to policyholders, the DEA will reduce the company's year-end reserves for purposes of Section 807. This ensures that the earnings allocable to the policyholders' equity interest is taxed at the corporate level whether or not distributed to policyholders.

[12] If no premium is fixed in the contract, however, variations in premiums paid during the course of the contract are not considered premium adjustments. Also, any premium change that is attributable to the insurability of the insured is not considered a premium adjustment. H. Rep't No. 98-432, *supra* note 1 at 1421; S. Rep't No. 98-169, *supra* note 1 at 548; *General Explanation* at 611.

[13] See, *e.g.*, *Rev. Rul.* 82-133, 1982-2 CB 119; *Rev. Rul.* 69-444, 1969-2 CB 145; *Rev. Rul.* 67-180, 1967-1 CB 172. This reverses *Republic National Life Ins. Co.*, 594 F.2d 530 (CA-5, 1979), which had held under prior law that experience rated refunds made to nonparticipating group policyholders pursuant to a fixed formula were properly classified as return premiums and not dividends to policyholders.

[14] The conclusion in *Lincoln Nat. Life Ins. Co.*, 582 F.2d 579 (Ct. Cls., 1978) relating to the deduction for unpaid group experience rated refunds attributable to open policy years is precluded under the 1984 Act.

[15] *Cf.*, *Ltr. Rul.* 7831003 (exact amount of a strip-mining liability must be determinable by a computation based on presently known or knowable factors).

[16] The reduction of the policyholder dividends deduction cannot exceed on a cumulative basis the amount of the company's 1984 fresh start adjustment for policyholder dividends. See Joint Committee on Taxation Staff, *Description of the Technical Corrections Act of 1985 (H.R. 1800 and S.814)* (hereinafter referred to as "Description of Technical Corrections Act") 56-57 (4/4/85).

[17] Congress may have chosen to reduce the reserve deduction rather than to tax the policyholders' share of tax-exempt income directly to avoid a constitutional challenge. See *Atlas Life Ins. Co.*, 381 U.S. 233 (1965).

[18] Such distributions, unless funded with tax-exempt interest or with dividends not eligible for the 100% dividends-received deduction, have already been taxed at the subsidiary level. Absent an exception for dividends funded out of tax-exempt income, a parent life insurance company could avoid proration by having its subsidiary own all the exempt obligations and distribute the exempt interest earnings to the parent as a dividend eligible for the 100% dividends-received deduction. S. Rep't No. 98-169, *supra* note 1 at 530.

There appears to be no policy reason to explain why dividends from a wholly owned foreign subsidiary subject to Section 245(b) are excluded from the definition of 100% dividends. These dividends, to the extent made out of earnings effectively connected with the conduct of a trade or business within the U.S., also have been taxed at the subsidiary level.

controversies as to what deductions are properly allocable to investment income are eliminated. "Gross investment income" for this purpose includes tax exempt interest but does not include dividends eligible for the 100% dividends-received deduction except to the extent paid, directly or indirectly, out of tax-exempt income.

The proration formula used under the 1984 Act is similar to that used under prior law in computing "Phase II" gain or loss from operations. The policyholders' share of net investment income, however, is expanded to include not only required interest on reserves, but also three other items: (1) excess interest; (2) any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholders' fund under a pension plan contract for active employees or to a deferred annuity contract before the annuity starting date; and (3) the gross investment income's proportionate share of policyholder dividends for the taxable year. Like prior law's "Phase II" computation of proration, interest paid to creditors (individuals other than customers) is not an included item. In addition, the technical corrections bill would amend Section 812(b)(2) to add as a fourth item "interest on amounts left on deposit with the company."[21] The amounts of a mutual's excess interest, policyholder dividends, etc. taken into account for this purpose are the "deductible portions" determined under Sections 808 and 809, *i.e.*, the portions remaining after a pro rata reduction of the mutual's policyholder dividend deduction by the DEA. Thus, the DEA that reduces a mutual's policyholder dividend deduction also reduces ratably the items taken into account in the policyholders' share.

Required interest on reserves (other than unearned premiums and unpaid losses included in total reserves under Section 816(c)(2)) is determined at the prevailing state assumed rate. When no prevailing state assumed rate exists for an item listed in Section 807(c), it is unclear how the required interest (if any) is determined. For example, the prevailing state assumed rate could be considered to be zero in these circumstances, in which case the entire amount credited on the reserve could constitute excess interest. To avoid this problem, the technical corrections bill would require that "an appropriate rate" be used in these circumstances. Presumably, the contract rate would be an appropriate rate.

For purposes of proration, "traditional" policyholder dividends are treated more favorably than excess interest and amounts credited to pension plans because only the gross investment income portion of such dividends is included in the policyholders' share. This portion is determined by a "mini-fraction."[22] The application of the mini-fraction to the deductible portion of policyholder dividends[23] reflects a recognition by Congress that some portion of "traditional" policyholder dividends consists of redundant premiums and not investment income. In contrast, excess interest and amounts in the nature of interest credited to pension plans and deferred annuities are viewed as paid out of investment income and subject to proration in full. Premium and mortality charge adjustments on excess interest contracts are viewed as paid entirely out of premium income and are not subject to proration.

Policyholders' surplus accounts

Under prior law, three deferral items were added to a policyholders' surplus account of stock life insurance companies, and were subject to a "Phase III tax" only when actual or deemed distributions to shareholders exceeded the shareholders' surplus account.[24] Since the deferral items have been eliminated under the new law, Section 815(d)(2) provides that there will be no further additions to policyholders' surplus accounts after 1983. The previously deferred amounts, however, are not forgiven but are subject to tax when such amounts are treated as distributed to shareholders. Actual distributions include dividends, redemptions, and "boot" in otherwise tax-free reorganizations. When the policyholders' surplus account exceeds certain levels of reserves or premiums, the excess is treated as a distribution. Because the amount of the distribution is treated as an addition to LICTI, a distribution from the policyholders' surplus account is taxed at the full corporate rate; it cannot be offset by life insurance company losses and is not subject to the special and small life insurance company deductions.

Although no new amounts will be added to the policyholders' surplus account, additions will continue to be made to the shareholders' surplus account. Specifically, the excess of the sum of the following amounts over taxes imposed for the year (without regard to the "Phase III tax") is added to the shareholders' surplus account: (1) LICTI (but not below zero); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the dividends-received deduction allowed the company under Section 805(a)(4); and (5) tax-exempt interest. Unlike prior law, certain capital gains and the policyholders' share of the dividends-received deduction are not added to the shareholders' surplus account.

Section 815(a) expands prior law to encompass "indirect" distributions. The Committee Reports suggest that this reference to "indirect" was intended to

[19] The policyholders' share of tax exempt interest and the dividends-received deduction is 100% reduced by the company's share of that item.

[20] To take into account the significantly smaller investment expenses with respect to assets held in segregated asset accounts, the technical corrections bill would define net investment income (in the case of gross investment income attributable to assets held in a segregated asset account underlying variable contracts) to mean 95% of gross investment income. See *Description of Technical Corrections Act* at 62.

[21] For example, the policyholders' share of net investment income under Section 812(b) would include interest paid on deposit administration contracts which provide no permanent purchase rate guarantees. See *Description of Technical Corrections Act* at 62.

[22] The numerator of the mini-fraction is gross investment income, as defined by Section 812, less the deductible portions of any (1) excess interest, (2) policyholder dividends on pension plan contracts for active employees or on deferred annuity contracts before the annuity starting date, and (3) premium and mortality charge adjustments with respect to contracts paying excess interest for such year. The denominator of the mini-fraction is life insurance gross income (including tax-exempt interest) reduced by the net increase (if any) in Section 807(c) reserves.

Because the calculation of the items in the denominator requires that the policyholders' share of tax-exempt interest first be determined (see Sections 803(a)(2) and 807), a circularity problem exists with respect to the denominator of the mini-fraction. To eliminate this circularity problem, the technical corrections bill would redefine the denominator of the mini-fraction to be life insurance gross income reduced by the net increase (if any) in Section 807(c) reserves. For this purpose, life insurance gross income would be determined by including tax-exempt interest and computing any decreases in reserves without any reduction of the closing balance of the reserve items by the company's share of tax-exempt interest. See *Description of Technical Corrections Act* at 62.

[23] The deductible portion of policyholder dividends to which the mini-fraction applies is determined under Section 812(b)(3) by reducing the deductible portion of policyholder dividends by the sum of the deductible portions of (1) excess interest; (2) policyholder dividends on pension plan contracts for active employees or on deferred annuities before the annuity starting date; and (3) premium and mortality charge adjustments with respect to contracts paying excess interest for such year.

[24] The three deferral items under prior law were (1) one-half of a stock company's excess gain from operations over taxable investment income; (2) special deductions for nonparticipating contracts; and (3) special deductions for group life and accident and health contracts.

[25] H. Rep't No. 98-432 *supra* note 1 at 1410-1411; S. Rep't No. 98-169, *supra* note 1 at 536; *General Explanation* at 594. See also *Union Bankers Ins. Co.*, 64 TC 807 (1975) (Section 304(a)(2) transaction treated as a constructive distribution).

[26] See H. Rep't No. 98-861, 98th Cong., 2d Sess. 1050 (1984).

[27] *Supra*, note 1 at 594.

codify prior case law which held that a constructive distribution triggered the Phase III tax.[25] In an expansion of prior law, however, the legislative history suggests that an indirect distribution can occur whenever policyholders' surplus account funds are used to benefit shareholders.[26] The Joint Committee's *General Explanation*[27] illustrates this interpretation by an example of a loan to the parent whether or not for adequate consideration. The proposed technical corrections bill would foreclose this interpretation by providing that an indirect distribution does not include a bona fide loan with arm's-length terms and conditions (determined by reference to Section 482 and the Regulations thereunder).[28] If the loan is not arm's-length, however, the entire amount of the loan (not merely the interest component) is treated as a distribution.

Variable contracts

Section 817 continues the special accounting rules under prior law for variable annuities and contracts with reserves based on segregated asset accounts, but conforms their tax treatment to that of variable pension plan contracts under prior law.[29] In addition, the 1984 Act provides specific statutory recognition of variable life insurance and extends the special accounting rules to such contracts. Accordingly, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining reserve increases or decreases must be adjusted to reflect appreciation and depreciation in the value of assets. The company's bases in the assets underlying the variable contracts also are adjusted for appreciation or depreciation reflected in the reserve adjustments, thereby eliminating any corporate capital gains or losses with respect to such assets.

In addition, an adjustment also is provided for any appreciation or depreciation during a year affecting deductions for death claims, etc., under Section 805. This adjustment applies only to the extent of such appreciation or depreciation, and not in the greater amount that such appreciation or depreciation affects death benefits. For example, if $100 appreciation in the value of separate account assets increases death benefits by $200, the amount of the adjustment to death benefits would be $100.[30]

Treasury is given regulatory authority to prescribe diversification standards for investments of segregated assets accounts underlying variable contracts other than contracts for qualified retirement plans. This authority replaces the ruling standards used by the Service and should, once Regulations are issued, reduce the need for a letter ruling. A safe harbor is granted if the diversification requirements applicable to a regulated investment company are met and no more than 55% of the assets are cash, cash items, government securities, or securities of other regulated investment companies. Ownership by a segregated asset account will not be treated as a single investment (but will be considered to have the diversification of the underlying fund) so long as all shares of the underlying fund are owned by one or more segregated asset accounts for insurance companies. There is also an exception from the investment diversification standards if a segregated asset account invests only in Treasury securities.[31]

If the diversification requirements are not met, the variable contract based on the account will not be treated as an annuity, endowment, or life insurance contract for purposes of Subchapter L, Section 72, and Section 7702(a). Congress was silent in the new legislation as to when and to what extent a contractholder will be taxed if the contract fails the diversification standards.[32]

Reinsurance

The basic rules governing the taxation of reinsurance are the same as under prior law.[33] However, the Service's authority under former Section 818(g) to make proper adjustments to allocate or recharacterize an item subject to a reinsurance agreement is greatly expanded. Under prior law, the Service's allocation authority applied only to reinsurance agreements between related parties (within the meaning of Section 1239). New Section 845(a) substitutes a Section 482 test for related parties. Thus, two or more parties are related if they are organizations or entities owned or controlled directly or indirectly by the same interests, whether or not they are incorporated or affiliated. In addition, Section 845(a) extends to reinsurance transactions between unrelated parties if one of the parties to a reinsurance agreement is in effect an agent of another party to such agreement or a conduit between related persons.[34] The Service also is granted broad authority under Section 845(b) to make "proper adjustments" any time it determines that any reinsurance contract (whether between related or unrelated parties) has a significant tax avoidance effect on any party to the contract. A typical adjustment will be to treat the contract as terminated on December 31 of each year and reinstated on January 1 of the next year.

The legislative history outlines the purpose and scope of Section 845 in general terms. It explains that: (1) the allocation authority applies to both life and nonlife insurance companies; (2) objective standards apply to determine whether an adjustment is appropriate, *i.e.*, the motivations of the parties generally are irrelevant; (3) the existence of a business

[28] Although the statutory reference to indirect distributions refers to amounts out of the shareholders' *and* policyholders' surplus accounts, the legislative history to the 1984 Act and the explanation of the technical corrections bill suggest that a constructive distribution may result only when policyholders' surplus account amounts are used to benefit shareholders. An example of an indirect distribution would be where funds are used to purchase stock of a parent or an affiliated company or by using funds to make loans within an affiliated group for less than adequate consideration. See *Description of the Technical Corrections Act, supra* note 16 at 64.

[29] Under prior law, a life insurance company was not taxed on the ordinary income allocable to policyholders under variable annuity contracts and pension plan contracts held in a segregated asset account. The insurance company was taxed on capital gains in the case of a nonpension contract but not in the case of a pension contract.

[30] H. Rep't No. 98-432 *supra* note 1 at 1419 n.18; S. Rep't No. 98-169, *supra* note 1 at 546 n.13; *General Explanation of the Joint Committee Staff* at 607 n.27.

[31] The technical corrections bill would clarify the exception for investments in Treasury securities. Generally, to the extent that any segregated asset account with respect to a variable life insurance contract is invested in Treasury securities, the investments made by such account will be treated as adequately diversified.

In addition, the technical corrections bill provides an expanded "look-through" rule which allows for the use of seed money, or for the ownership of fund shares by an insurance company or fund manager for administrative convenience, in operating an underlying investment fund.

[32] See *Rev. Rul.* 77-85, 1977-1 CB 12; *Rev. Rul.* 80-274, 1980-2 CB 27; *Rev. Rul.* 81-225, 1981-2 CB 12; *Rev. Rul.* 82-54, 82-1 CB 11; *Christoffersen*, 749 F.2d 513 (CA-8, 1984).

[33] The prior law distinction between assumption reinsurance and indemnity reinsurance continues. See Sections 803(a)(3) and (b)(1)(E), and 805(a)(6) re assumption reinsurance; Sections 803(a)(1)(A) and (B), 803(b)(1)(F) and (2)(B), and 805(d)(7) re indemnity reinsurance.

[34] Whether a party is an agent of, or conduit between, other parties is determined in light of all facts and circumstances. For example, control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured would be evidence to establish that an agency relationship exists. H. Rep't No. 98-452 *supra* note 1 at 1492; S. Rep't No. 98-169 *supra* note 1 at 556; *General Explanation* at 634.

[35] Some questions on the scope of Section 845 include: (1) Are correlative adjustments required between related parties? (2) Are arm's-length standards or business purposes ever relevant in determining whether Treasury's adjustment authority should be exercised? (3) Is the tax effect on the other party relevant to determining whether Treasury's authority should be exercised? (4) Do the reinsurance adjustment provisions apply to assumption reinsurance transactions? (5) Can income be allocated to a party that could not legally receive such income? (6) Does the adjustment authority extend to termination of reinsurance agreements?

purpose or arm's-length standards, or the absence of tax avoidance or evasion as a principal purpose, will not foreclose the Service's allocation authority; (4) correlative adjustments need not be made; and (5) allocation authority extends to any agreement characterized by the parties as reinsurance and the Service's exercise of the authority will not preclude it from arguing that the agreement is not a reinsurance transaction for other tax purposes.

Whether a reinsurance contract has a tax avoidance effect is determined by taking into account the time value of money. The critical determination, however, is whether a tax avoidance effect is "significant." This will be the case where the transaction is designed so that the tax benefits enjoyed are disproportionate to the insurance and economic risks transferred.

The legislative history lists seven factors which may suggest that a significant tax avoidance effect exists, none of which alone are determinative. These factors are: (1) the duration or age of the business reinsured; (2) the character of the business reinsured; (3) the structure for determining the potential profits of each of the parties and any experience rating; (4) the duration of the reinsurance agreement; (5) the rights of the parties to terminate the reinsurance agreement; (6) the relative tax positions or brackets of the parties; and (7) the general financial situations of the parties.

In addition, the legislative history lists four types of reinsurance transactions that generally will not require the Service to exercise its adjustment authority. These safe harbors will apply (possibly to both Sections 845(a) and (b)) until Regulations (that will have prospective effect) are issued: (1) yearly renewable term reinsurance; (2) coinsurance of annual renewable term life insurance; (3) coinsurance covering new business which allocates expenses and income items between the parties in the same proportion as the allocation of the risk reinsured; and (4) coinsurance covering existing business if the initial ceding commission reflects the proper allocable share of past expenses of the ceding company and any premium paid reflects anticipated profitability of the reinsured business.

The scope of these provisions suggests that they will have an enormous impact on reinsurance (whether or not tax motivated).

If the Service uses its reinsurance allocation authority aggressively, the unresolved questions undoubtedly will generate litigation. In the meantime, until Regulations are issued or the scope of Section 845 is established in litigation, the statute and its legislative history may have an *in terrorem* impact.[35]

Conclusion

In the 1984 Act, Congress eliminated some of the perceived tax abuses and benefits under prior law but did little to simplify life insurance company taxation other than to eliminate the three-phase structure. It continued some of the old complexities (*e.g.*, proration) and added new ones (*e.g.*, the distinction between insurance and noninsurance business). It remains to be seen whether the new concepts—such as the mutual add-on tax, the reinsurance allocation authority, and recomputed tax reserves—create a viable permanent legislative solution to the problem of how to tax the industry, and each segment thereof. ☆

FORTHCOMING TAX MEETINGS

32nd Annual Colby Estate Planning and Tax Institute. Sponsored by Colby College. July 22-23, Colby College, Waterville, Maine. Topics include: estate planning for qualified compensation plan benefits, tax planning for small businesses. Contact: Robert H. Kany, Director, Special Programs, Colby College, Waterville, Maine 04901. (207) 872-3386.

Real Estate and Leasing Transactions in the Shadow of Tax Reform: Structuring Marketable Deals for '85. Sponsored by Legal Times/Law & Business, Inc., and Fordham University School of Law. July 22-23, The Cathedral Hill Hotel, San Francisco; September 19-20, The Ambassador West Hotel, Chicago. Contact: Law & Business, Inc., 855 Valley Road, Clifton, New Jersey 07013. (201) 472-7400 or (800) 223-0231.

Planning with Personal Computers and Electronic Spreadsheets. Sponsored by Colby College. July 24-25, Colby College, Waterville, Maine. A hands-on seminar, limited to 30 registrants. Contact: Robert H. Kany, Special Programs, Colby College, Waterville, Maine 04901. (207) 872-3386.

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Fourth Annual Estate Planning Seminar. Sponsored by Estate Planning Council of Mobile, Inc. August 16, Stouffer Riverview Hotel, Mobile, Alabama. Contact: Ruth Norris, Executive Director, Mobile Estate Planning Council, 4362 Midmost Drive, Mobile, Alabama 36609.

Estate Planning Institute. Sponsored by the University of Colorado Law School. August 17-18, University of Colorado, Boulder. Topic: an in-depth discussion of estate planning for practitioners. Contact: John Birchman, Office of Conferences/Services, 500 30th Street, Campus Box 454, Boulder, Colorado 80310. (303) 492-5151.

20th Annual Southern Federal Tax Institute. Sponsored by Southern Federal Tax Institute, Inc. September 30-October 4, Hyatt Regency Atlanta, Atlanta, Georgia. Topics include: acquisitions of partnership interests, computer-related products for use in tax practice, multi-investor transactions, FSCs, interest deductions, qualified plans after TEFRA, DEFRA, and REA, flexible and executive compensation, collapsible corporations, divorce taxation, real estate, Section 337, acquisitive reorganizations, estate planning for family assets, use of life insurance. Contact: Southern Federal Tax Institute, Inc., 407 Cain Tower, 229 Peachtree Street, N.E., Atlanta, Georgia 30303. (404) 524-5252.