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In-House Tax Advisors and Actuaries Beware on Product Taxation

by Peter H. Winslow and Susan J. Hotine

On June 20, 2005, new and more stringent standards of practice went into effect under IRS Circular 230 for tax consultants (lawyers, accountants and possibly actuaries) who practice before the IRS and provide tax advice. To oversimplify matters, any written tax advice (including electronic communications) that is intended to be relied upon to avoid penalties or is intended to be used in marketing, must rise to the status of a formal written opinion, that considers all the relevant facts and federal tax issues. Any tax advice that falls short of a formal opinion that reaches a confidence level of more likely than not on all significant tax issues must prominently state something like the following:

> "This document does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the document. With respect to those significant Federal tax issues, this document was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."

In addition, if the tax consultant understands that the tax advice may be used in marketing, IRS Circular 230 requires that the document disclose any compensation arrangement between the tax consultant and the promoter, indicate that it was written to support marketing and recommend that the taxpayer seek advice from an independent tax advisor.

Generally, tax advice given by an in-house tax advisor is not subject to these rules to the extent the tax advisor is providing the advice in his/her capacity as an employee solely for purposes of determining his/her employer's tax liability. Importantly, however, there is no exception for tax advice from in-house tax professionals that addresses the tax treatment of customers. Likewise, there is no exception for "customer" tax advice based on whether or not the tax advice is used internally or in marketing materials.

An issue has been raised whether anyone who gives an "opinion" covering federal tax issues in connection with an arrangement or plan that has a significant tax avoidance purpose is deemed to be practicing before the IRS, whether or not that person is a lawyer or accountant. Does the circular apply, for example, to an in-house or consulting actuary when he/she prepares a written analysis of IRC §7702 compliance that is intended to be used exclusively within the company? At least one IRS representative has said that the IRS Circular 230 requirements only apply to lawyers, accountants, enrolled agents and, in some cases, enrolled actuaries [as listed in section 10.2(e)]. Other IRS officials and commentators have disagreed, however. Even if it applies, it is unclear what sanction could be imposed on an actuary's non-compliance if the actuary never practices before the IRS. Therefore, concern over whether the IRS Circular 230 requirements apply to an actuary's work product may be more theoretical than practical.

As a result of the newly effective provisions of IRS Circular 230, life insurance companies should review their marketing materials and actuaries should review their current internal practices to determine whether they are in compliance and, if not, whether the appropriate disclosure or disclaimer language should be added to written tax materials.

The IRS Goes Paperless – Notice 2005-35

by Brian G. King

Those who have been involved with IRS filings to remediate inadvertent modified endowment contracts (MECs) or failed life insurance contracts know that the filing requirements can be onerous. Taxpayers are required to file paper reports at a contract level, generating between one and four (or more) pages per contract, resulting in recent submissions that have exceeded 10,000 pages! With the recent issuance of Revenue Ruling 2005-6 providing guidance on the treatment of qualified addition benefits (QAB) under IRC §7702 and §7702A, the IRS became aware of the likelihood that taxpayers would be filing submissions including policy number listings in the hundreds of thousands.

Revenue Ruling 2005-6 provides that for purposes of determining whether a contract qualifies as life insurance under IRC §7702, and as a MEC under IRC §7702A, charges for QABs must be taken into account under the expense charge rule of IRC §7702(c)(3)(B)(ii). The revenue ruling provides three alternatives to companies whose compliance systems do not currently account for charges for QABs under the expense charge rule of IRC §7702(c)(3)(B)(ii). Under Aternatives B and C of the ruling, a company may request relief in the form of a closing agreement under which the contracts will not be treated as having failed the requirements of IRC §7702(a) or as a MEC under IRC §7702A by reason of improperly accounting for charges for existing QABs. The company's request for a closing agreement must include a list identifying the contracts for which relief is requested.

According to Notice 2005-35, the IRS is aware that for certain taxpayers, a list identifying the contracts subject to the closing agreement may be sufficiently large that it could be burdensome for the taxpayer to provide the list on paper. In response to this concern, the IRS is allowing taxpayers to submit the list electronically. Taxpayers must provide three files in read-only format, each file must be on either a CD-ROM or diskette and the files must be in Adobe portable document format (other formats are acceptable provided the IRS has preapproved the format). Let's hope that the electronic filing under this notice is successful in the eyes of the IRS and opens the door for electronic submissions for other IRC §7702 and IRC §7702A closing agreements as well.

IRS Attempts to Avoid Income/Deduction Mismatch for Deferred and Uncollected Premiums

by Peter H. Winslow and Susan J. Hotine

In CCA 200504030 (Oct. 15, 2004), the IRS Chief Counsel adopted the position that a change in computing life insurance reserves to remove net deferred and uncollected premiums (D&U premiums) is a change in method of accounting rather than a change in basis of computing life insurance reserves. This conclusion had significant economic and practical consequences to the taxpayer in the CCA. If the correction for D&U premiums is considered to be a change in method of accounting, IRC §446(e) provides that securing the Commissioner's consent is a condition to the change. The consent requirement applies even though the failure to back out D&U premiums is erroneous. Another consequence of characterizing the D&U premium change as a change in method of accounting is that IRC §481 requires an adjustment to prevent a double deduction or a double inclusion of income that otherwise would result from the change. A change to reduce reserves for D&U premiums will result in a double deduction for reserves in an amount equal to the opening balance of D&U premiums for the year of the change. Therefore, an unfavorable IRC §481 adjustment, increasing taxable income in an amount equal to such opening balance of D&U premiums, will be required, and such amount at best will be spread over four years. Rev. Proc. 97-27, 1997-1 C.B. 680, modified by Rev. Proc. 2002-19, 2002-1 C.B. 696. On the other hand, if the D&U premium change qualifies as a change in basis of computing reserves from an erroneous reserve method to the reserve method authorized by the Code, no permission from the IRS is needed and the adverse adjustment to eliminate the double deduction arising from the change is spread over 10 years under IRC §807(f). Rev. Rul. 94-74, 1994-2 C.B. 157. Therefore, in these circumstances, there is a significant advantage if IRC §807(f) applies and a 10-year spread is allowable.

> At first blush, it may appear that the IRS Chief Counsel is wrong; the reduction in reserves for D&U premiums seems to be a change in basis of computing reserves to which IRC §807(f) applies.

At first blush, it may appear that the IRS Chief Counsel is wrong; the reduction in reserves for D&U premiums seems to be a change in basis of computing reserves to which IRC §807(f) applies. However, it is not that simple. The requirement in the statute for reducing reserves for D&U premiums is found in IRC §811(c)(1), which provides that no reserve can be established for any item unless the gross amount of premiums attributable to the item is required to be included in life insurance gross income. Because IRC §811(a) adopts an accrual method of accounting for premiums, and D&U premiums usually are not accrued, they are not required to be included in life insurance gross income. Therefore, D&U premiums should be excluded from both premiums and, as a result, also excluded from reserves. A correction in timing for reporting premium income is a change in method of accounting requiring the consent of the Commissioner under IRC §446(e). So, the issue becomes: Is the reserve correction for D&U premiums a change in method of accounting because it is driven in the first instance by the treatment of an income item? Or, is the D&U premium income and the resulting reserve effects treated as two separate items subject to different change rules?

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The taxpayer in the CCA adopted a literal reading of the statute and treated the change in the income item and the resulting change in the reserve treatment as two separate items. First, it corrected the reserves by eliminating D&U premiums. It did so without seeking the Commissioner's consent as authorized by Rev. Rul. 94-74. The taxpayer presumably then followed the rules of IRC §807(f) and spread the adverse adjustment resulting from the change over 10 years. On the premium side, the taxpayer treated the correction as a change in method of accounting by filing a Form 3115 seeking the IRS' consent. The taxpayer probably sought to take the favorable IRC §481 adjustment to eliminate the double inclusion of D&U premiums, which would otherwise be caused by the accounting method change, all in one year under Rev. Proc. 2002-19. The combined result of a favorable IRC §481 adjustment and the spread of the unfavorable IRC §807(f) amount was unacceptable to IRS Chief Counsel.

The Chief Counsel's solution to avoid the mismatch of the one-year favorable IRC §481 adjustment and the 10-year spread of the unfavorable IRC §807(f) amount was to say, without analysis, that the reserve change for D&U premiums is a change in method of accounting requiring the Commissioner's consent. Although the Chief Counsel's position is understandable, questions might be raised with respect to that position and the technical analysis (or lack thereof) supporting it. IRC §811(c)(1) mandates that a reserve not be established with respect to an item when premiums attributable to that item are not "required" to be included in income; by its terms, then, if premiums are erroneously included in income, but not "required" to be so included, a taxpayer is not permitted to establish a reserve for the item to which those erroneously included premiums relate. Thus, except to the extent that the inclusion of the D&U premiums was required (i.e., except to the extent those premiums were accrued), the taxpayer was computing its reserves with respect to the D&U premiums incorrectly. What if the taxpayer had not sought a change in method of accounting for the income inclusion of D&U premiums? Is the taxpayer supposed to remain on what IRC §811(c)(1) indicates is an incorrect method for computing reserves? Or, based on the literal wording of IRC §811(c)(1), could the IRS require a change in basis of computing reserves on audit? If the IRS tried to force a reserve change to the correct method, can the IRS require an accounting method change for the income inclusion of the D&U premiums? Given its published position in Rev. Proc. 97-27, 1997-1 C.B. 680, as modified by Rev. Proc. 2002-19, 2002-1 C.B. 696, is there any way for the IRS to impose a 10-year spread of the favorable IRC §481 adjustment for premiums to match the IRC §807(f) 10-year spread? Probably not, if the premium income and reserve computation changes are treated as two separate items.

The Chief Counsel's solution, without analysis and ignoring these kinds of questions, is to call "it" a change in method of accounting. The Chief Counsel appears to have concluded that the offsetting premium income and reserve adjustments are a single item for accounting purposes and, therefore, IRC §807(f) never enters into the equation. Arguably, this is a strained application of accounting method change provisions (including IRC §807(f)) in light of the language of IRC §811(c)(1). Perhaps that is the best the Chief Counsel could do under the circumstances.

Companion IRC §7702 and 7702A Closing Agreements Can Reduce Toll Charges

by Stephen P. Dicke

Typically, when an insurer seeks a closing agreement from the IRS to correct "failures" of a life insurance contract to meet the prefunding limits under IRC §7702 (for tax qualification as a life insurance contract) or IRC §7702A (to avoid adverse tax status as a modified endowment contract or MEC), the IRS will require a separate closing agreement for §7702 failures and another separate closing agreement for §7702A failures. Each closing agreement will require a separate "toll charge" to be paid by the insurer to the IRS for the correction, and generally this toll charge will be based on some measure (or part) of the "income on the contract" or earnings for each corrected policy.

More recently, some insurers have asked the IRS to allow simultaneous corrections in the same policies to correct both §7702 and §7702A failures, e.g., by making one refund of "excess" premium from each policy that is sufficient to correct both its §7702 and its §7702A failures at the same time. Such simultaneous corrections not only can save administrative costs for the insurer, but also could lead to a reduction in the total amount of toll charges payable to the IRS. The IRS continues to require separate closing agreements for such simultaneous §7702 and §7702A corrections. However, the IRS is now willing under certain circumstances to allow a reduction in the combined toll charges for "companion" §7702 and §7702A closing agreements with the same insurer, to the extent that these "companion" closing

agreements cover the same policies. Such a reduction in the combined toll charges may be allowed in the form of a credit or offset against the toll charge due in the second closing agreement, to reflect some portion of the toll charge that is being paid with the first closing agreement.

The question in the TAM was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with MGDBs that were issued before the adoption of NAIC AG34.

IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date

by Peter H. Winslow and Susan J. Hotine

In general, tax reserves qualifying as life insurance reserves are required to be computed under IRC §807(d) and related IRC sections by starting with statutory reserves as computed in the NAIC Annual Statement and then making six adjustments:

1) Use of the tax reserve method prescribed by the NAIC (CRVM for life insurance or CARVM for annuities) as of the issue date;

2) Substitution of the applicable federal interest rate in effect as of the issue date for the statutory rate;

3) Substitution of standard mortality or morbidity tables prevailing in 26 states as of the issue date;

4) Reduction for net deferred and uncollected premiums;

5) Reduction for benefits attributable to excess interest guarantees beyond the end of the taxable year; and

6) Elimination of deficiency reserves.

These actuarially computed tax reserves are then subject to a statutory reserve cap and a net surrender value floor with the cap and floor applied on a contract-by-contract basis.

In TAM 200448046 (Nov. 26, 2004), the IRS addressed a situation where, at the time variable annuity contracts with minimum guaranteed death benefits (MGDBs) were issued, the NAIC had no clear guidance as to how the Commissioner's Annuity Reserve Valuation Method (CARVM) applied to the MGDBs. The legislative history sets forth general rules to resolve cases like this where there are varying interpretations of CARVM as of the issue date. First, as of the date of issue of a contract, the taxpayer is required to use the method prescribed by the NAIC and take into account any factors recommended by the NAIC for such contracts; factors to be taken into account are generally addressed in actuarial guidelines (AG) issued by the NAIC. Second, where no NAIC AG exists, or for contracts issued prior to the NAIC's adoption of a guideline, taxpayers are to look to the prevailing interpretation of the Standard Valuation Law, i.e., the interpretation that has been adopted by at least 26 states. Absent an NAIC guideline or a prevailing interpretation of the states, the tax reserve method should follow the interpretation used by the taxpayer for its statutory reserves as long as the statutory method is one of several permissible interpretations of the SVL as of the issue date. This is because, except for the six federally prescribed items outlined above, tax reserve assumptions are required to be the same as those used for statutory reserves.

In TAM 200448046, the IRS purported to follow these rules set forth in the legislative history, but it is questionable whether it did so properly. The question in the TAM was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with MGDBs that were issued before the adoption of NAIC AG 34. For statutory purposes, the taxpayer had used the method required by the Connecticut Insurance Department which, for purposes of computing the MGDB reserves reported in the Annual Statement, required an assumption of a one-third drop in asset value. The Connecticut asset-drop assumption was not required by any other state as of the issue date of the contracts and resulted in greater reserves than were required under the AG 34 method that subsequently was adopted.

Before the adoption of AG 34, it was unclear how to reserve for MGDBs. Some companies held separate reserves computed as if the net amount currently at risk were a separate life insurance contract subject to

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Commissioner's Reserve Valuation Method (CRVM). Others held no additional reserves on the theory that the MGDBs did not provide the stream of benefits that yielded the greatest present value as compared to other benefits. A few companies computed MGDB reserves assuming some type of asset-drop. In light of this wide range of practices, the authors are unaware of a prevailing state interpretation of CARVM prior to the adoption of AG 34. Under these circumstances, the taxpayer should have been required to use the Connecticut-imposed reserve method on the Annual Statement. The reserve method was merely one of many permissible interpretations and there was no NAIC guideline or prevailing state interpretation in effect that addressed the issue of reserving for MGDBs.

TAM 200448046 reaches a different conclusion, however. Instead of attempting to determine whether there was a prevailing state interpretation of how CARVM applied with respect to MGDBs, the IRS concluded that the taxpayer could not use the Connecticut method because at least 26 states permitted smaller reserves for MGDBs. In its analysis, the TAM appears to have injected two new principles into determining what is a prevailing state interpretation—principles that do not appear in the statute or the legislative history. First, implicit in the TAM's reasoning is that a prevailing view of the states can be gleaned from passive acceptance by state regulators of CARVM interpretations made by companies filing Annual Statements. Second and more importantly, the TAM's reasoning interposes a minimum reserve requirement on the prevailing-state-interpretation standard of how CARVM should be applied when an item is not addressed directly by the NAIC. That is, even though there was no single prevailing state interpretation of CARVM with respect to the treatment of an item (e.g., MGDBs), and even though a majority of states viewed several interpretations of CARVM as permissible, the TAM concludes that reserves must be computed using the method that yields the smallest reserve permitted by at least 26 states. The TAM gives no guidance as to what interpretation of CARVM this may have been for MGDBs before the adoption of AG 34.

The TAM's analysis is questionable and in apparent conflict with the legislative history's discussion of a company's permitted use of either continuous or curtate functions in computing CRVM reserves. A majority of states permit either assumption; yet the legislative history suggests that the assumption used for statutory reserves governs. In these circumstances, there is no requirement to use curtate functions because they are permitted to be used by 26 states and their use may yield the smallest reserve. In other words, in determining whether there is a prevailing state interpretation of the Standard Valuation Law, the focus is supposed to be on whether the states have adopted a single view as to what is the proper interpretation of CRVM or CARVM, and not on whether there is one of several permissible interpretations yielding the smallest reserve that at least 26 states allow. Lacking a prevailing state interpretation for applying CARVM to MGDBs, in TAM 200448046 the IRS appears to have adopted a new standard that an assumption for computing reserves is not "permissible" unless it has been adopted by 26 states and yields the minimum reserve that can be held for the benefit. Such a position is not prescribed by the statute and is contrary to explanations of the tax reserve provisions in the legislative history.

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