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What to do About Tax Reserve Estimates

by Peter H. Winslow

We frequently are asked what to do when a company has reported aggregate estimates of tax reserves on the tax return, instead of tax reserves computed precisely according to the requirements of the Internal Revenue Code, and the IRS has challenged the reserve deduction. Companies faced with this problem usually are aware that reserve estimates are technically not permitted because life insurance reserves must be computed on a seriatim basis. Under I.R.C. § 807(d), tax reserves for life insurance or annuity contracts are required to be computed in accordance with Commissioner's Reserve Valuation Method (CRVM) or Commissioner's Annuity Reserve Valuation Method (CARVM), which is defined by the NAIC in the Standard Valuation Law in terms of the characteristics of a particular contract (e.g., benefits, premiums, issue date). Moreover, after the CRVM or CARVM is computed using the federally prescribed interest rate and mortality table, the reserve is compared to the statutory reserve and the net surrender value on a contract-by-contract basis. Despite these requirements, the ideal of the Internal Revenue Code is not always matched by reality and, due to time or data constraints, tax reserve estimates find their way into the tax return. When this compliance failure is discovered on audit, the IRS examiner typically disallows the year-end reserves (or any amount in excess of the net surrender values that can be established).

There are several potential ways to respond to the IRS in this audit situation, depending on whether the corrected reserves are greater or smaller than the estimate reported. The first step is to make sure that the IRS examiner treats the reserve disallowance as reserve weakening subject to I.R.C. § 807(f). Application of the reserve weakening rules has the dual benefit of deferring for one year any reduction in reserves for the contracts issued before the taxable year, and spreading the reserve decrease ratably over 10 years. The economic impact of the 10-year spread rule can be dramatic. In fact, for lines of business with high lapse rates, a reserve decrease coupled with a 10-year spread actually may be beneficial. A beneficial result is not unusual in these circumstances because tax reserve estimates most often occur in small specialty lines that are in a run-off status. Thus, a company may not want to argue with the reserve disallowance at all. If this fortuitous situation is not present, the position a company will want to take will depend on the answers to the following questions:

1. Is it possible to now compute precise tax reserves on a seriatim basis?

2. Is it possible to prove actuarially to the IRS examiner that properly computed tax reserves in excess of the net surrender value would be allowable if the exact computations were to be made?

3. If the answer to 1 and/or 2 is "yes," will the resulting tax reserves be greater or smaller than the reserves reported on the original tax return?

4. If correctly computed tax reserves would be greater, what is the first open year in which recomputations can be made?

5. If the answer to 3 is "greater," would an increase in reserves subject to I.R.C. § 807(f) in the first open year be better or worse than no change (i.e., how quickly do the reserves run off)?

Assuming correct tax reserves can be computed and would be greater, the change would be beneficial despite application of the 10-year spread rule of I.R.C. § 807(f). In this situation, the company probably should go through the effort of responding to the IRS examiner with properly computed reserves, and consideration should be given to filing claims for refund for prior years starting in the earliest open year under the authority of Rev. Rul. 94-74, 1994-2 C.B. 157. Corrections for prior years not only may result in refunds of tax, but they also can have the beneficial effect of reducing the adverse impact of the 10-year spread.

This strategy of filing refund claims for prior years also is advisable even if the company would prefer that the IRS not make an adjustment to increase reserves, either because it is too much work to actually compute the

correct reserves or because an increase in reserves is not beneficial due to the 10-year spread. Most IRS examiners and appeals officers are willing to concede proposed adjustments that appear to be beneficial in the current year (even if they may have adverse tax consequences in future years). This is particularly true where consistent treatment of the reserve item would result in refunds for prior open years. In such circumstances, it may be possible to negotiate a favorable resolution with the IRS examiner or appeals officer, without computing the exact reserves merely by proving that the reserves will likely increase and result in refunds for earlier years.

What should be avoided is a compromise that results in a reserve disallowance followed by a correction increasing reserves in a subsequent year with the increase subject to a 10- year spread.

The more difficult situation to deal with is when it is too difficult or too costly to compute exact tax reserves, and the company cannot demonstrate to the IRS' satisfaction that the proper reserves would be equal to or greater than the reported tax reserves. In these situations, creative solutions should be proposed that have as their ultimate outcome a transition to correctly computed reserves at a reasonable tax cost. For example, consideration could be given to computing exact tax reserves for the current year and seeking a compromise with the IRS whereby allowable tax reserves in interim years will be determined by grading to the correct amount. What should be avoided is a compromise that results in a reserve disallowance followed by a correction increasing reserves in a subsequent year with the increase subject to a 10-year spread.

Valuation of Insurance In Force for Tax Purposes

by Peter H. Winslow and Samuel A. Mitchell

Where an election is made under I.R.C. § 338 to treat an acquisition of the stock of an insurance company as an asset acquisition, Prop. Treas. Reg. § 1.338-11 provides that the deemed asset sale and purchase shall be treated as if it occurred by assumption reinsurance for tax purposes. To determine the gain on the ceding company's deemed sale and the tax basis to the deemed reinsurer, allocation of the total purchase price to particular assets requires a determination of the fair market values of the assets. For purposes of determining the portion of the total consideration allocable to the insurance in force, Prop. Treas. Reg. § 1.338-11(b)(2) has a special rule that provides that fair market value "is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to old target's tax reserves for the contracts."

It is unclear what this means and how it would effect, if at all, an actuarial appraisal of insurance in force. It is possible that reference to tax reserves in the proposed regulations could go to the very heart of the assumptions that are made by the actuary. To appreciate this, it may be useful to describe some of the basic principles of an actuarial appraisal that set this type of appraisal apart from valuation techniques generally applied to intangible assets in other industries.

When appraisers in other business contexts use an income approach to value income-producing contractual rights, they typically look to anticipated future cash flows that they assume will be generated from ownership of the intangible asset, and then apply a discount rate to determine the asset's present value. An actuarial appraisal uses the same general income approach to valuation of insurance in force, but with a major variation—it uses distributable earnings based on statutory accounting for the assumed future income stream, instead of future cash flows. The reasoning behind the variation for an actuarial appraisal is that the use of cash flows would misstate true economic value to a purchaser because the cash cannot be distributed to the owners until profits emerge under statutory accounting principles.

The use of distributable earnings in an actuarial appraisal not only has the effect of deferring earnings, but also can have the effect of converting what ordinarily would be considered a liability into an asset. This can be illustrated by how the insurance industry views a paid-up life insurance contract. Most general business appraisers would assume that a paid-up contract is a liability, not an asset. After all, there is no future positive cash flow in the form of premiums that will be generated by the contract. However, an actuarial appraiser would assume that the premiums have not yet been earned on the contract and, in effect, will be received by the company in the future as the reserves are released. Stated differently, an actuarial appraiser assumes that assets equal to the reserves belong to the policyholders, not the company. Therefore, the actuarial appraiser's valuation assumes that assets equal to the statutory reserves will be transferred in the sale of a block of business. For this reason,

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the use of statutory accounting and distributable earnings in an actuarial appraisal converts an economic liability into a valuable intangible asset from which future earnings will be generated.

Getting back to the proposed regulations, what does it mean when it says that tax reserves should be used instead of statutory reserves to determine the ceding commission transferred to the reinsurer? Is the actuary supposed to perform an ordinary actuarial appraisal using statutory distributable earnings to determine future income, and then increase that value by the difference between statutory and tax reserves based upon the proposed regulations' apparent assumption that the reinsurer would be willing to accept a smaller gross reinsurance premium (i.e., the perceived value to the reinsurer is greater)? This literal application of the proposed regulations seems to have the opposite result of what may have been intended because, in an actual assumption reinsurance transaction, the ceding commission (i.e., the purchase price) for tax purposes is usually determined by the difference between the fair market value of the assets transferred and the amount of tax reserves. That is, the deemed value of the insurance in force as measured by the ceding commission is smaller for tax purposes as a result of using tax reserves as the measure of the ceding commission. Another possible interpretation of the proposed regulations is that "fair market value" should be determined by adjusting future distributable earnings used in the appraisal by assuming that tax reserves, rather than statutory reserves, are required to be held. Under either interpretation of the proposed regulations, the "fair market value" of insurance in force may be different from what the parties to the stock transaction actually assumed in their negotiations and also different from true fair market value. For this reason, in a letter to the IRS dated Aug. 28, 2002, the American Council of Life Insurers recommended that this special definition of fair market value be eliminated from the final regulations.

Estates of Employees Covered by COLI Plans May be Entitled to the Death Benefits Paid to the Employers, But the IRS Says They Are Not Entitled to a Tax Exclusion for the Benefits

by Peter H. Winslow and Susan J. Hotine

The IRS attacked employers' deductions for broad-based corporate-owned life insurance (COLI) plans (or "janitor insurance"), arguing that the policy loans, the interest payments and sometimes even the insurance itself are economic shams. At the same time, the estates of rank-and-file employees covered by these plans have sought to recoup the death benefits paid to employers, claiming that the employers did not have an insurable interest in the lives of the employees because the employers' economic interest in the continued life of the employees was not substantial. In these circumstances, the laws of many states provide that, while insurers still have contractual obligations to pay death proceeds, the estates of the covered employees in whose lives the employer had no insurable interest have a cause of action to recover those proceeds. Although the death proceeds were paid to the employers, courts have recognized the legal claims of the employees' estates against employers for such proceeds, or have recognized a constructive trust for such proceeds in favor of the employees' estates.[1]

While courts seem to be saying that the employees' estates are the proper recipients of the COLI death proceeds for rank-and-file employees, the IRS has concluded that the amounts so received are not death proceeds, or at least not "amounts received . . . under a life insurance contract, . . . paid by reason of the death of the insured" for purposes of the tax exclusion under I.R.C. § 101(a). In PLR 200528023 (July 15, 2005), the IRS considered facts involving a class action settlement of claims filed on behalf of former employees who died while covered by the employer's COLI policies, similar to the facts of the *Mayo v. Hartford Life Ins. Co. and Tillman ex rel. Estate of Tillman v. Camelot Music, Inc*. cases. The facts of the PLR state that initially an employee's estate brought suit against the employer, claiming that the employer did not have an insurable interest in the life of the employee and, therefore, was not the rightful beneficiary for the policy on his life. The employee's estate then requested certification of a class of similarly situated employees. In the course of the litigation, the parties settled and the funds paid by the employer were put into a trust for the settlement class. Each qualified former employee's estate or heir received a proportionate amount of the settlement fund determined on the basis the face amount of each policy. The employee's estate apparently argued that under the origin of the claim doctrine, the proceeds distributed from the settlement class trust were excludable from income pursuant to I.R.C. § 101(a) because the proceeds retained their character as insurance proceeds paid by reason of death on the insured persons.

[1] See *Mayo v. Hartford Life Ins. Co.*, 354 F.3d 400 (5th Cir. 2004); *Tillman ex rel. Estate of Tillman v. Camelot Music, Inc.*, 408 F.3d 1300 (10th Cir. 2005).

The IRS noted that the court had held that the contracts between the insurer and the employer were valid, even though the employer lacked an insurable interest. Under such circumstances, the proceeds received by the employer upon the deaths of the covered employees were proceeds paid by reason of death of the insured. The IRS then noted that the court's decision permitted the estates to sue for monies improperly converted by another party, saying that the estates' recovery was for funds that were converted by the employer. The IRS concluded that, because the amounts recovered by the estates were pursuant to a settlement of the claims raised in the litigation to recover converted funds, the amounts distributed from the settlement class trust were not insurance proceeds paid by reason of death.

The PLR's analysis focuses on the fact that the court found the COLI contract to be valid, even though the employer had no insurable interest, but fails to consider the consequences of the state-law finding that the employer had no insurable interest. Certainly, in a situation where state law imposes a constructive trust on the employer for the proceeds, the implication is that the proceeds do not belong to the employer, or more specifically, that the employer was not the proper beneficiary of the policies. Even the cause of action to recover "converted funds" implies that the employer converted, for its own use, funds that did not belong to it. The PLR does not really address the estates' argument that, under state law, the estates (and not the employer) are the proper beneficiaries of the COLI contracts covering employees in whom the employer had no insurable interest. Because the court found the COLI contracts to be valid, the IRS concluded that the named beneficiary was the only person entitled to received the proceeds paid by reason of death. Finding that the contracts were valid certainly means that the insurer is contractually required to pay out the proceeds. However, a finding that the employer has no insurable interest effectively may mean, under state law, that the employer is not a proper beneficiary of those proceeds, and that, as a necessary consequence, someone other than the employer must be the proper beneficiary. If the estates had sued the employer and raised the insurable interest question prior to the death proceeds being paid out, and if the court had ordered the insurer to pay the proceeds directly to the employees' estates, it is unlikely that the IRS would have arrived at the same conclusion that the death benefits were not paid by reason of the death of the insureds. Similarly, then, any amounts paid to the estates in settlement of their claims to the death proceeds—that is, in lieu of the death proceeds—paid by the insurer probably should be tax-exempt under I.R.C. § 101.

Because the court found the COLI contracts to be valid, the IRS concluded that the named beneficiary was the only person entitled to received the proceeds paid by reason of death.

We can speculate why the IRS concluded as it did. The IRS may have been concerned that the employer had long ago excluded the death proceeds from its income under I.R.C. § 101 and a second exclusion for the employees' estates would be inappropriate because the employer now may have an argument for a deduction for the settlement payments. However, there are a number of theories the IRS could have used to deny a tax benefit to the employer, rather than choose to deny the I.R.C. § 101(a) exclusion to the employees' estates. For example, the IRS could have argued that either no deduction is allowable because the death proceeds never belonged to the employer and, if they did, the deduction is disallowed under I.R.C. § 265(a) as allocable to tax-exempt income. Denial of a tax benefit to the employer, coupled with an income exclusion to the employee for the death benefits, would put all parties where they should be under I.R.C. § 101.[2] ◀

[2] See *Nahey v. Commissioner*, 196 F.3d 866 (7th Cir. 1999).

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