T3: *Taxing Times* Tidbits

Actuaries Weigh in on IRS Circular 230

by Peter H. Winslow and Susan J. Hotine

In the September 2005 issue of *Taxing Times*, we raised a question as to whether § 10.35 of IRS Circular 230, issued June 20, 2005, could apply to in-house or consulting actuaries who prepare written tax analysis (e.g., under I.R.C. § 7702), but do not practice before the IRS. It appears that, in drafting that section of the Circular, the IRS intended that its provisions would apply to enrolled actuaries who prepare actuarial reports (Forms 5500, Schedule B) for qualified plans. Under Circular 230, any written tax advice that is expected to be relied upon to avoid penalties, to be used in marketing or is another type of "covered opinion," must consider all the relevant facts and federal tax issues.

By letter dated October 28, 2005, the American Academy of Actuaries submitted comments on § 10.35 of Circular 230, which pointed out serious flaws in the IRS requirements as they relate to valuation reports prepared by pension actuaries.

Confidentiality—Under the Circular, a "covered opinion" includes written tax advice with respect to any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax if the advice is subject to conditions of confidentiality. The Academy pointed out that actuarial reports usually require confidentiality to prevent inappropriate third-party reliance and that the rules for "covered opinions" serve no purpose in this context.

Incomplete Data—The Academy took issue with the Circular's prohibition against basing an opinion on incomplete data pointing out that actuarial valuations are performed routinely despite missing data. The Academy argued that actuarial standards of practice should govern on whether or not the data is sufficient to render an opinion.

Qualified Plan Exception—Circular 230 provides that written advice, which concerns the qualification of a qualified plan, is not a covered opinion subject to the IRS' stringent requirements unless the advice relates to a plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax. The Academy had many comments on this provision. Primarily, it sought confirmation that creation or maintenance of a qualified plan should never be considered a transaction, which has the principal purpose of tax avoidance or evasion. It also sought clarification that advice routinely provided by pension actuaries will be within the scope of this exception, even if the advice does not technically relate to a plan's qualification (e.g., advice relating to minimum funding or distribution requirements).

Best Practices—Circular 230 provides guidance on "best practices" of tax practice. Although this guidance is labeled merely "aspirational," the Academy noted that failure to follow the guidance could be used by plaintiffs' attorneys in civil court actions to impeach the work of actuaries. To minimize this risk, the Academy requested more specificity in this section of the Circular so that it could not be used inappropriately in private litigation.

At their core, the comments of the Academy reflect a desire for pension actuaries to be excluded from the requirements of Circular 230 when they are acting in their capacity as actuaries. After all, actuaries do not practice tax law and, although they frequently are required to interpret relevant provisions of the Internal Revenue Code and practice before the IRS, they do not provide legal tax advice. So far, the IRS has expressed a reluctance to revisit § 10.35 of Circular 230 to narrow its scope in the many areas where it has been criticized as overreaching. It remains to be seen whether the Academy's comments will be received favorably and acted upon.

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

Susan J. Hotine is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. She may be reached at *shotine@scribnerhall.com.*

Stephen P. Dicke is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *sdicke@scribnerhall.com.*

Reformation of Insurance Contracts

by Peter H. Winslow and Stephen P. Dicke

A recent private letter ruling (PLR) issued by the IRS National Office reminds us that adverse tax consequences that may flow from the literal language of an insurance policy sometimes can be avoided if that literal language is contrary to the actual agreement of the insurer and the policy owner. In PLR 200603002 (Oct. 24, 2005), a husband and wife each owned life insurance policies, which named the owner as a beneficiary. The husband and wife created a revocable trust and executed a document entitled "transfer by gift" signed by the husband

and wife and their four children that set forth the terms of gifts that the husband and wife intended to make to the trust on behalf of the children. Under the terms of the transfer by gift, the husband and wife were to exchange their policies for a single last-to-die policy that would be transferred to the trust, with the trust designated as the new owner. Contrary to instructions, the insurance agent made a mistake and caused the new policy to list the husband and wife as joint owners. When the husband and wife discovered the mistake, they moved to reform the insurance policy, and sought the PLR from the IRS that the policy reformation would not result in a transfer for gift and estate tax purposes.

The IRS noted that, although the general rule is that the terms of the policy govern, there is an exception to the rule where the insurance contract itself does not reflect the intentions of the parties. A leading tax case that followed this principle is *Estate of Fuchs v. Commissioner*, 47 T.C. 199 (1966), acq., 1967-1 C.B. 2, where the court held that the value of life insurance policies was not includable in a decedent's estate, even though the policy terms gave the decedent incidents of ownership, because the insurance agent had been instructed that the beneficiaries were to be designated as sole owners. In applying the principle of the *Estate of Fuchs* case to the facts in PLR 200603002, the IRS concluded that the trust should be considered to be the owner of the joint and survivor policy from its inception, despite the insurance agent's mistake. Based on this conclusion, the IRS ruled that the reformation would not result in a gift or estate tax transfer in the year of the reformation, but was a gift at the time of the original transfer to the trust.

In reaching its conclusion, the IRS stated: "We cannot see any distinction between the situation when an agent gratuitously adds an unwanted clause in an insurance policy and the situation presented herein when the agent fails to include a desired provision or removes an undesired one." This observation presents a valuable reminder that, in appropriate circumstances, reformation of a contract may be appropriate where, through inadvertence and contrary to the mutual intent of the parties, a life insurance or annuity contract is missing a rider or other provision that was intended to ensure the contract's tax qualification. For example, suppose a life insurance company markets its annuity contracts as tax-favored investments, but forgets to attach a distribution-at-death rider that was designed to ensure their tax qualification as annuity contracts under I.R.C. § 72(s). Assume that the insurer administers its annuity contracts, including the contracts with the missing riders, in compliance with I.R.C. § 72(s). In these circumstances, the parties would have a strong argument that the contract reformation principle relied upon by the IRS in PLR 200603002 applies here as well, so that the contracts can be reformed to reflect the mutual intent of the parties to comply with I.R.C. § 72(s) from the original issue date.

Resisted Claims Are Deductible by Life Insurance Companies

by Peter H. Winslow and Lori J. Brown

It is well settled that an insurance company, which is not taxed as a life insurance company for federal income tax purposes, is entitled to deduct resisted claims as part of its reserves for losses incurred. Rev. Rul. 70-643, 1970-2 C.B. 141. Resisted claims are those losses reported to an insurance company for which the company either denies liability or contests the amount of its liability for the loss. Resisted claims on casualty and accident and health policies are deductible subject to discounting under I.R.C. § 846. Resisted claims on life insurance policies, as a practical matter, are deductible in the full amount reported on the annual statement by a non-life insurance company, even though it may be unlikely that the company will pay all of the claims. This is because the reasonableness of the losses incurred deduction is tested on an aggregate basis and the IRS is not authorized to disallow a deduction for the portion of resisted claims the company does not expect to pay without first establishing that the aggregate deduction for all losses incurred is outside a reasonable range. Rev. Proc. 75-56, 1975-2 C.B. 596.

For life insurance companies, the treatment of resisted claims is more complicated. For casualty-type resisted claims, including claims on accident and health insurance contracts, the same general rules applicable to non-life companies apply to life companies, i.e., resisted claims are included in full in losses incurred and are deductible on a discounted basis under § 846. Rev. Rul. 72-432, 1972-2 C. B. 400. However, controversies frequently arise on audit with respect to resisted death claims arising under life insurance contracts.

First, IRS agents often attempt to disallow the deduction for resisted claims on the basis that: (i) death claims are not includable in the reserves for unpaid losses under I.R.C. § 807(c)(2) and (ii) are deductible on an accrual basis under I.R.C. § 811(a), which places life companies on an accrual method of accounting for non-reserve items. See Rev. Rul. 72-115, 1972-1 C.B. 200. Because the claims are resisted, they generally do not meet the requirements for a deduction under the accrual method. It is doubtful whether this argument of IRS agents has any continuing validity after the Tax Reform Act of 1986. The legislative history strongly suggests that Congress intended life and non-life companies to be treated alike with respect to unpaid losses, including resisted claims. S. Rep. No. 313, 99th Cong., 2d Sess. 500-01 (1986). In addition, Congress added the last sentence of I.R.C. § 807(c), which, by negative inference, suggests that unpaid death claims on life insurance contracts are included in unpaid losses under

continued ▸▸16

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. He may be reached at *pwinslow@scribnerhall.com.*

Lori J. Brown is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP. She may be reached at *lbrown@scribnerhall.com.*

from pg. 15

I.R.C. § 807(c)(2) on an undiscounted basis. Perhaps in recognition of this, the Internal Revenue Manual at 4.42.3.3.1(8) now provides that resisted claims "due to suicide or misrepresentation in the application" are allowable if they are supported by "an allocation based on historical development."

Second, IRS agents may argue that a deduction for the full amount of resisted claims is not allowable. Unlike non-life companies, which typically can deduct the full amount of resisted claims (after taking into account any applicable discounting) because they have a large amount of claims in other lines and the aggregate deduction for unpaid losses is considered reasonable, life companies usually have a small number of total unpaid claims at year-end. This increases the likelihood that the IRS will be able to challenge the reserve for resisted claims on the basis that it is not reasonable. That is, according to the IRS, it is unreasonable to assume that 100 percent of resisted claims will be paid, but it is reasonable for a life insurance company to deduct resisted claims on life policies on the basis of historical development. However, because of the small number of claims by the life company, in many cases, the historical development of prior resisted claims may not be a reliable measure of the amount the life company actually expects to pay on the current year claims. Nevertheless, establishing a deduction for resisted claims based on an historical development percentage is supported by the Internal Revenue Manual and may be preferable to a deduction based on a case-by-case analysis of the settlement value of each resisted claim.

FAS 109 Interpretation Likely Effective in 2007

by Brian G. King

On July 14, 2005, the Financial Accounting Standards Board ("FASB" or "the Board") issued an exposure draft on proposed Interpretation, Accounting for Uncertain Tax Positions—an Interpretation of FASB Statement No. 109 (FAS 109). (See article outlining the details of the proposed Interpretation in the December 2005 issue of *Taxing Times*). FAS 109 is designed to clarify when tax benefits may properly be recognized and to reduce the diversity in accounting for taxes.

In light of the numerous comment letters solicited on the proposed interpretation, the Board is expected to make several modifications. The final interpretation, reflecting these changes, is expected during the first half of 2006.

As originally drafted under the proposed interpretation, the recognition of a tax benefit would occur when it is "probable" that the position would be sustained on audit. The Board is expected to change the initial recognition standard from probable to "more likely than not." The probable standard was meant to have the same meaning that it has in FASB Statement No. 5 (FAS 5), Accounting for Contingencies. The FAS 5 definition of probable (i.e., that which is likely to occur—determined to be about 70 percent) represents a level of assurance that is substantially higher than more likely than not (i.e., a level of likelihood greater than 50 percent).

It is also expected that the final Interpretation will reflect a one-year delay from the effective date in the proposed interpretation, making the standard effective in 2007 for most companies. The effective date in the proposed Interpretation was for fiscal years ending after December 15, 2005.

Taxing Times will continue to comment on further updates or modifications to interpretations on FAS 109, if and as, they develop.

AFR at a Record Low

by Bruce Schobel

On November 18, 2005, the IRS released its table of applicable federal interest rates (AFRs) for December 2005. The mid-term annual interest rate for December 2005 was 4.52 percent. This rate was the last of the 60 monthly figures needed to determine the 2006 AFR for purposes of IRC section 807. IRC section 807 prescribes the assumptions and methodology for computing Federally prescribed reserves. The result of this rolling average calculation was a rate of 3.98 percent. This 2006 AFR for section 807 is the lowest that this rate has ever been, and is well below the comparable 2005 rate of 4.44 percent (the previous recorded low).

For the second consecutive year, the section 807 AFR is lower than the prevailing state assumed rate (PSAR) for all types of contracts. The PSAR for long-term life insurance contracts issued in 2006 is only slightly higher at 4.0 percent. When the PSAR is higher than the AFR, section 807 states that the PSAR is the rate that must be used to compute Federally prescribed reserves. Thus, tax reserves and statutory reserves are essentially equal. This is good news with respect to surplus. When the AFR exceeds the PSAR, as was the case for more than 15

Brian G. King, FSA, MAAA, is a vice president with Aon Consulting in Avon, Conn. He may be reached at *brian_king@aon.com.*

Bruce Schobel, FSA, MAAA, is a vice president and actuary with New York Life Insurance Company. He may be reached at *bdschobel@aol.com.*