T[3]: *Taxing Times* Tidbits

NAIC to Extend Actuarial Guideline XXXIX for Two Years

by Peter H. Winslow

Actuarial Guideline XXXIX (AG 39) sets forth valuation standards (CARVM) for variable annuity contracts with guaranteed living benefits (VAGLB) In general, the guideline provides that aggregate reserves for contracts with VAGLB must equal the sum of (1) aggregate reserves for the contracts ignoring both the future revenues and benefits from the VAGLBs after comparison to the cash values and (2) the sum of an accumulation of the aggregate VAGLB charges from the date of issue to the valuation date, subject to an aggregate asset adequacy analysis AG 39 was written as a temporary stopgap guideline, pending a comprehensive study expected to result in the issuance of VACARVM. For this reason, the original AG 39 had a sunset date of Jan. 1, 2006.

Defining CARVM for variable annuities with VAGLBs, AG 39 became the tax reserve method required to be used for tax purposes under I.R.C. § 807(d)(3) for contracts issued after its adoption by the NAIC. However, the new valuation rules have presented some difficult tax compliance issues. It seems clear that the Standard Valuation Law, and therefore I.R.C. § 807(d), require both statutory and tax reserves to include a provision for VAGLBs What is not so clear is the amount of that provision for tax purposes. Is the CARVM reserve for the contract under I.R.C. § 807(d) equal to the basic reserve, plus the accumulation reserve? Or, does it also include the additional provision for asset adequacy? Do either of the accumulation reserve or the asset adequacy addition have to be recomputed for tax purposes? If so, many of the same tax reserve issues that tax lawyers, accountants and actuaries are dealing with now in the context of developing VACARVM and Principles-Based Reserves are implicated. For example, if the asset adequacy portion of the reserve is part of the CARVM reserve, how is it recomputed for tax purposes, taking into account the interest rate and mortality tables prescribed by I.R.C. § 807(d)? How is it compared to net surrender values on a contract-by-contract basis? Whatever the answers to these questions may be, they probably will not be determined with any certainty for another two years At the fall meeting of the NAIC, the Life and Health Actuarial Task Force amended the guideline to delay the sunset date to Jan. 1, 2008, in the hope that VACARVM can supplant AG 39 before that new sunset date.

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Private Annuities Are Now Just Like Commercial Annuities If Purchased with Property

by Susan J. Hotine

On Oct.18, 2006, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) released proposed regulations addressing the tax treatment of an exchange of property for an annuity contract, whether it be a private annuity or commercial annuity contract Prop Treas Reg. § 1.1001-1(j) and 1.72-6(e) provide that, if an annuity contract is received in exchange for property other than money, the transferor-taxpayer (i) realizes an amount equal to the fair market value of the annuity contract (as determined under tables prescribed by Treasury under I.R.C. § 7520 for valuing of any annuity, interest for life or term of years, or any remainder or reversionary interest) at the time of the exchange; (ii) is required to recognize the amount of the gain or loss, if any, at the time of the exchange, regardless of the transferor-taxpayer's method of accounting; and (iii) for purposes of determining the initial investment in the annuity contract under I.R.C. § 72(c)(1), will treat the amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract) as the aggregate amount of the premiums or other consideration paid for the annuity contract. In addition to not distinguishing between private and commercial annuity contracts, the proposed regulations do not distinguish between secured and unsecured private annuity contracts. However, the proposed regulations specifically would not apply to an annuity contract that either is a debt instrument subject to I.R.C. § §1271 through 1275, or is received from a charitable organization in a bargain

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sale governed by Treas. Reg. § 1 1011-2. The proposed regulations apply whether the property is exchanged for a newly-issued annuity contract or for an existing annuity contract. Also, if the exchange of property for the annuity contract is in part a sale and in part a gift, the proposed regulations would apply the same rules that apply under I.R.C. § 1001.

The proposed regulations generally would be effective for exchanges of property for an annuity after Oct. 18, 2006. Thus, the proposed regulations would not apply to payments under an annuity contract received in exchange for property before that date (*i.e.*, existing private annuities). Also, there is an April 18, 2007 effective date for a limited class of transactions in which the annuity issuer is an individual, the annuity obligation is not secured in any way and the property transferred is not subsequently sold or disposed of by the transferee for two years after the date of the exchange. For purposes of this latter requirement, a disposition includes a transfer to a trust (whether a grantor trust, a revocable trust or any other trust) or to any other entity even if solely owned by the transferor. The later effective date has been described as applicable only for "plain vanilla, family-style annuities." Comments on the proposed regulations are due Jan. 16, 2007, with a hearing scheduled for a month later, in February.

The proposed regulations ostensibly were designed with the intention of treating property exchanges for private annuities the same as exchanges for commercial or secured annuity contracts; to leave the transferor-taxpayer in the same tax position as the transferor that sells the property for cash and uses the proceeds to purchase an annuity contract. The preamble thus indicates that, consistent with the proposed guidance, upon finalizing the proposed regulations, Treasury and the IRS propose to declare a decades-old ruling (Rev. Rul 69-74, 1969-1 C.B. 43) obsolete, effective contemporaneously with the proposed regulations. Rev. Rul 69-74 concludes that the gain realized on the exchange of appreciated property for a private annuity is recognized ratably over the duration of the annuity payout period, as part of the portion of each annuity payment that is not excludable from income.

Although the proposed regulations seem to be aimed at undermining the transferor-taxpayer's argument that an unsecured private annuity is a mere promise to pay and does not amount to "property" received in an exchange, it may be questionable whether the aim is achieved. The proposed regulations speak only in terms of property exchanged for an "annuity contract." What is the tax treatment of the transaction if the property is exchanged for a "private annuity" that does not contain the distribution-at-death provisions required under I.R.C. § 72(s)? If the "private annuity" does not contain the required distribution-at-death provisions, it is not an annuity for purposes of the Code. *See* I.R.C. § 72(s)(1). Presumably, the proposed regulations would not apply. Would the installment sale rules then apply?

Maybe an installment sale would be better—The preamble to the proposed regulations notes that taxpayers are free to choose to dispose of property under the I.R.C. § 453 installment method, provided the requirements of such section are met. Under I.R.C. § 453(a), income from the sale of real property or a casual sale of personal property, where any payment is to be received after the taxable year of the sale, must be taken into account under the installment method unless the transferor-taxpayer elects out in a timely manner.[1] Thus, an installment sale is defined broadly as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. *See* I.R.C. § 453(b)(1). The disposition of property for any I.R.C. § 72(s) disqualified "annuity contract" would meet this general definition. So, what would be the consequences? Under an installment method, the transferor-taxpayer recognizes income from the disposition of the property with each installment payment received, the income being that proportion of the payment received in a year which the gross profit bears to the total contract price; the taxpayer also recognizes an interest charge and recovers basis ratably over the installment period similar to the recovery of basis with the exclusion ratio under I.R.C. § 72(b). In fact, regulations prescribe how basis will be recovered "ratably" even where the gross profit or the total contract price cannot be readily ascertained. *See* I.R.C. § 453(j)(2); Temp. Treas. Reg. § 15A.453-1(c)(2)-(4). In contrast with the treatment given for property exchanged for an annuity contract, under the installment method, the gain from the property disposition would be taken into income only as each installment payment is made[2] and, with the exception of the interest charge, such installment income would be treated as gain from the disposition of the property (*e.g.*, capital gain).[3] The preamble to the

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[1] I.R.C. § 453(e) also provides for a termination of the installment method where the sale is to a related person and there is a subsequent resale of the property within two years of the initial sale

[2] Note that I.R.C. § 453(f)(4) provides that receipt of a bond or evidence of indebtedness that is payable on demand or readily tradable is treatment as receipt of payment. On the other hand, evidence of indebtedness from the transferee that is guaranteed by another party is not a payment. See I.R.C. § 453(f)(3)

[3] This installment method provides treatment for the transferor-taxpayer that is very similar to that of Rev. Rul. 69-74, which provides that a portion of the income received under the annuity would be taxed as capital gain and the rest as ordinary income

proposed regulations requests comments on when an exchange of property for an annuity contract should be treated as an installment sales. Perhaps the answer should be "when the contract is not an annuity." Lack of distribution-at-death provisions required under I.R.C. § 72(s) would be evidence of same.

Deferred Compensation Transition Relief Extended Through End of 2007

by Mark H. Kovey

Section 409A, enacted in late 2004, imposed new restrictions on nonqualified deferred compensation plans that require many employers to amend existing plans to bring them into compliance with the new law. Prior to its enactment there was little guidance, other than Internal Revenue Service (IRS) guidelines for private rulings, as to the standards for successfully deferring compensation under these popular plans. The new law has changed deferred compensation practices because, among other matters, it restricts the use of certain trusts to hold deferred amounts, limits when participant elections must be made to defer compensation and specifies when, and what form of, distributions can be made to participants.

Notwithstanding that Section 409A is effective generally to amounts of compensation deferred after Dec. 31, 2004, Notice 2005-1 provided initial guidance on implementing the new rules and transition relief for existing plans that were not in compliance with the new law. The relief provisions allowed employers, in many cases, to rely on the prior law through the end of 2005, provided they operated the plan in reasonable, good faith compliance with the new provisions and amended the plan to satisfy Section 409A by the end of 2005. On Oct. 4, 2005, proposed regulations under Section 409A were published that clarified and extended the transition relief. Anticipating that the final regulations would be made effective on Jan. 1, 2007, the preamble to the proposed regulations provided that amendments to bring existing plans into compliance with the new law generally did not have to be made until Dec. 31, 2006. Now, Notice 2006-79 extends the transition relief for most issues through the end of 2007. The final regulations are expected to be issued early in 2007, but with a delayed effective date of Jan. 1, 2008, to allow extra time for taxpayers to analyze the final regulations and bring their plans into compliance. The IRS has suggested that this is the last extension for transition relief.

Plans must be not only brought into compliance by Dec. 31, 2007, but also operated in good faith compliance in the interim. For example, the extension allows extra time to change an election to accelerate the payout to a participant of previously deferred amounts, provided the election change and any required amendment to the plan documents are made before Dec. 31, 2007. Therefore, a plan may provide, or be amended to provide, for new, different or accelerated distribution elections with respect to the time and form of payment of deferred amounts, and the new or changed election will not be treated as violating Section 409A.

However, Notice 2006-79 contains a "blackout" period for 2007, similar to the blackout period for 2006 under the transition relief in the proposed regulations. Consequently, no change to the plan and no election can be made under Notice 2006-79 in 2007 that causes an amount to be paid in 2007 when it would otherwise not be payable in 2007 or that impacts on an amount that would be payable in 2007.

Notice 2006-97 also extends the transition relief for making new deferral elections, payments linked to qualified employee benefit plans and the substitution of non-discounted stock options and stock appreciation rights (SARs) for discounted stock options and SARs. (Notice 2006-79 has no impact on those non-discounted stock options and SARs that are excluded from section 409A.) However, transition relief is not extended for those discounted stock rights that are subject to certain Securities Exchange Act disclosure and financial expense reporting rules. The IRS explained these are the types of stock rights which are involved in concerns over back-dating.

In a related area, an IRS official stated at a public seminar that the issuance of the final regulations under Section 409A will coincide with the IRS requiring employers to undertake reporting and withholding of income inclusions for 2006. The extension of transition guidance in Notice 2006-79 does not apply to information reporting and withholding obligations on deferred compensation that is includible in income under Section 409A. The official expected that employers will receive sufficient guidance to begin reporting and withholding by that time.

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Court of Appeals to Reconsider *Murphy* Case

by Samuel A. Mitchell and Peter H. Winslow

Tax lawyers and administrators normally do not have to think about the U S Constitution, but all that changed in August. On Aug. 22, 2006, for the first time in over 85 years, a court struck as unconstitutional a Congressional attempt to exercise its authority to tax income. In *Murphy v. United States*, the U.S. Court of Appeals for the District of Columbia held that I.R.C. § 104(a)(2) is unconstitutional to the extent that it permits taxation of items that are not income. 460 F.3d 79 (D.C. Cir. 2006). Specifically, the court held that damages awarded a plaintiff in a whistleblower suit for emotional distress, mental anguish and loss of reputation are recoveries of human capital and not "accessions to wealth." Based on a theory that taxpayers have no income in gaining emotional strength or reputation, the court held that an award for damages to compensate for the loss of these items is not income which Congress is authorized to tax under the 16th Amendment. The court essentially held that, unlike damages to compensate for future earnings that otherwise would have been taxed if earned, damages for emotional distress, mental anguish and loss of reputation merely return an individual to the *status quo ante*. As such, the court held that the damages are analogous to a nontaxable return of capital.

Practitioners widely criticized the *Murphy* case and the government views it as a matter of "exceptional importance to the administration of the nation's tax laws." Accordingly, the government filed a petition to have the case heard by the entire appeals court. (Petition for *en banc* review filed Oct. 2, 2006.) Perhaps in response to the heavy criticism the three-judge panel that originally heard the case recently vacated the earlier opinion and agreed to reconsider the case. (Order issued December 22, 2006.) In the order for reconsideration, the court vacated the earlier opinion, held that the government's petition for rehearing by the full court is moot, and ordered new briefing of the issues. This was a highly unusual move by the three-judge panel, and may signal a change in the result. The case will be argued again in April 2007.

The case is interesting and perplexing from a theoretical standpoint because I.R.C. §104(a)(2) is not a taxing provision, but rather is an exclusionary provision. I.R.C. § 61 broadly defines gross income to include any accession to wealth. I.R.C. § 104(a)(2) excludes from gross income "the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." In the vacated opinion, the court held that the plaintiff's damages for emotional distress, mental anguish and loss of reputation did not fall within this exclusion. Normally that would be the end of the matter. However, the court went on to conclude that, to the extent the exclusion permits the taxation of such items, it violates the 16th Amendment because such items are not income. In other words, the court held that I.R.C. § 104(a)(2) is unconstitutional, not because it taxes anything, but because it does not contain a broad-enough exclusion from taxation. Thus, as the government pointed out in its petition for *en banc* review, the decision would require Congress to enact an exclusion from gross income for the type of damages the plaintiff suffered.

The return of capital analogy is another interesting theoretical aspect of the case. This one has wide-ranging implications that may extend beyond I.R.C. § 104 situations if the plaintiff succeeds on reconsideration. A return of capital is not taxable because it merely restores basis that already has been taxed. For example, a company that issues a debt instrument is not taxed on the principal, but only on the interest that accedes to its wealth. Normally, the taxpayer must have a cost basis in order for the return to escape taxation. Courts have held that, because a person does not have a cost basis in items such as health, compensation for the loss of such items can be considered an accession to wealth. *E.g. Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983). The court in this case disagreed, holding that it was not necessary for the plaintiff to have a cost basis in her emotional and mental health and reputation because damages to compensate for the loss of these items merely restored her to the *status quo ante*.[1] As such, the court held that the damages do not represent an accession to wealth. This aspect of the holding, if it survives on reconsideration, may have wide-ranging implications because it calls into question the constitutionality of numerous Code provisions that result in taxation of items of gross income without permitting appropriate recognition of the taxpayer's cost basis.

There are other, basic Constitutional issues that will merit review on reconsideration. For example, in the petition for *en banc* review the government asked the full court to consider whether the government's authority to tax income derives from the 16th Amendment or from the basic taxing authority found in Article I

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[1] The government's stated answer to the human capital argument is that taxing damages for loss of health is not qualitatively different from taxing an award for loss of future earnings without an offsetting deduction for the exhaustion of a person's physical and mental prowess over the earnings period. (Petition for Rehearing, citing Boris Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* (3d ed 1999)). The government points out that the courts have uniformly rejected the human depreciation argument.

"to Lay and Collect Taxes, Duties Imposts, ..." According to the government, the court's three-judge panel missed the mark because the 16th Amendment merely removed the restriction on taxation of income from the apportionment and other requirements set forth in Article I, § 9, cl. 4. In other words, the government is arguing that the 16th Amendment merely governs how income can be taxed, and not whether it can be taxed. In opposition, the plaintiff contended that the government waived this argument by not raising it at trial or on appeal. (Response to petition for *en banc* review filed Oct. 31, 2006). Because of the significance of the case, the three-judge panel will most likely address this argument on reconsideration even though it was not raised the first time around.

On a more practical level, the case calls into question how structured settlements should be drafted and other issues of an administrative nature, such as whether an insurance company will continue to have a tax reporting obligation for the payment of unconstitutional I.R.C. § 104 items. For now, these issues are confined to the narrow geographic area covered by the D.C. Circuit (i.e., Washington, D.C.). However, if the government does not succeed on reconsideration, it almost certainly will seek Supreme Court review. Given the basic constitutional and tax administration implications of the case, odds are the Supreme Court will grant review if the government asks. This will not necessarily be the case if the government wins on reconsideration because the Supreme Court traditionally grants deference to the government's petitions for Supreme Court review that it does not afford to private litigants. Thus, the plaintiff, if she loses, is much less likely to gain entry to the Supreme Court.

Proposed Regulations on Capitalization of Tangible Assets Defer Decision on the De Minimis Rule

by Samuel A. Mitchell and Peter H. Winslow

The Internal Revenue Service (IRS) recently released proposed regulations under I.R.C. § 263(a) that clarify and expand current regulations regarding amounts paid to acquire, produce or improve tangible property. (REG 168745-03, August 21, 2006.) The rules provide a number of bright lines and safe harbors for application of the 12-month rule, treatment of repair and improvement expenses and other items such as unit of property rules that may not be of great interest to insurance company taxpayers. One area of interest to insurance companies and actuaries may be the IRS' discussion of a so-called "de minimis rule" under which small capital expenditures are routinely expensed for tax purposes as a matter of convenience, without any express legal authority to do so in the Internal Revenue Code or regulations. The proposed regulations do not include a de minimis rule, but the preamble solicits comments on whether to include a de minimis rule in the final regulations. The IRS held a public hearing on Dec. 19, 2006, but the de minimis rule was not a major topic of discussion.

Many taxpayers have informal agreements with IRS agents that acquisition expenditures in amounts below a certain threshold are off limits for examination—the de minimis rule. Although the proposed regulations do not contain a de minimis rule, the preamble contains a specific statement that the IRS does not intend this omission to disrupt current informal agreements. The IRS apparently considered adopting in the proposed regulations a de minimis rule that would set certain threshold amounts that would key off a taxpayer's written policies for expensing amounts paid for tangible property costing less than a certain dollar amount on its Applicable Financial Statement (AFS). Taxpayers without an AFS would have been subject to different, lower threshold amounts. The thresholds would not have applied to inventory property, improvements, land or components of a unit of property. The preamble solicits comments on whether the final regulations should retain the current informal agreement practice or adopt a rule similar to the AFS rule discussed above. Assuming a rule is adopted, the preamble requests comments on a variety of issues such as the proper threshold amounts, the scope of the rule, whether the rule should permit taxpayers and IRS agents to agree on higher thresholds, and whether a change to a new method should be treated as a change in method of accounting.

The preamble suggests that the IRS has an open mind on this issue and we can anticipate some flexibility on the part of the IRS National Office regarding the operation of the de minimis rule. This may be useful in dealing with agents who have not been flexible on this issue. ◂

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