T[3]: *TAXING TIMES* TIDBITS

DO WE FINALLY HAVE GUIDANCE ON SEPARATE ACCOUNT DRD?

By Susan J. Hotine

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The Internal Revenue Service (IRS) recently released Rev. Rul. 2014-7,[1] which addresses what is the amount of life insurance reserves taken into account under I.R.C. § 807 for a variable contract where some or all of the reserves are accounted for as part of a life insurance company's separate account reserves. Perhaps more important than what this ruling addresses is what it does not address. Rev. Rul. 2014-7 merely republishes the first, perhaps noncontroversial, holding of Rev. Rul. 2007-54[2] relating to the tax reserve amount for a variable contract. Rev. Rul. 2007-54 included a second holding, however, that stunned the industry with its conclusion that required interest for separate account reserves (which ultimately determines the company's share of the dividends-received deduction ("DRD")) should be calculated using the applicable federal interest rate.[3] This second holding would have had a significant negative financial impact on variable contract writers because following it would result in a substantial diminution to, if not elimination of, a company's share of the separate account's available DRD. The possibility of this negative financial impact was avoided by the publication of Rev. Rul. 2007-61,[4] which suspended Rev. Rul. 2007-54 and provided that the IRS would work on further guidance. Since 2007, every Priority Guidance Plan released by the Treasury Department and the IRS has included an item for "Revenue Ruling [or Guidance] on the determination of the company's share and the policyholders' share of the net investment income of a life insurance company under § 812." Rev. Rul. 2014-7 states that Rev. Rul. 2007-54 is modified and superseded, and that Rev. Rul. 2007-61 is obsoleted.

The first issue for consideration is: What does it mean when a ruling is modified and superseded? The IRS uses specific terms for explaining the effect that rulings have on previous rulings. In the "Definition of Terms" introduction of a Cumulative Bulletin, a ruling being "modified and superseded" is explained as describing "a situation where the substance of a previously published ruling is being changed in part and is being continued without change in part, and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self-contained. In this case, the previously published ruling is first modified and then, as modified, is superseded."[5] Whereas the first holding of Rev. Rul. 2007-54 is republished, the major modification of Rev. Rul. 2007-54 made by Rev. Rul. 2014-7 is the deletion of the second issue and holding, along with the entire analysis related to it. Thus, it appears that the IRS no longer takes the position that required interest for a federally prescribed reserve ("FPR") accounted for as part of the separate account should be calculated using the higher of the applicable federal interest rate of the prevailing state assumed interest rate. This would be consistent with the Industry Director Directive ("IDD")[6] that has been in effect since May 2010. By contrast, the IRS continues to take the position that all reserves for a variable contract, whether accounted for in the general account or the separate account, are taken into account under I.R.C. § 807(d). Having been so modified, Rev. Rul. 2007-54 is superseded by Rev. Rul. 2014-7. Rev. Rul. 2007-61 is obsoleted because the reason for suspending Rev. Rul. 2007-54—the second holding—no longer exists.

The second issue for consideration then is what exactly does Rev. Rul. 2014-7 stand for? As indicated above, Rev. Rul. 2014-7 republishes the first holding of Rev. Rul. 2007-54; it describes the same facts for Situation 1 and Situation 2, changing only the tax years referenced to more current years (2012 and 2013). Situation 1 considers a variable annuity contract that neither provides supplemental benefits nor involves qualified substandard risks. The facts indicate that for each year the FPR for the contract ($8,000 and $10,000, respectively) is greater than the net surrender value ($7,840 and $9,830) and less than the statutory reserve ($8,050 and $10,045). Situation 2 considers the same variable annuity contract except that the contract provides a minimum guaranteed death benefit ("MGDB"). The facts indicate that for each year the total of the general account and separate account FPRs for the contract with the MGDB is larger than in Situation 1 ($8,155 and $10,165), but that the FPR for the contract without the MGDB (i.e., the separate account FPR) would have been the same as in Situation 1 ($8,000 and $10,000). Also, in Situation 2, for each year the net surrender value of the variable annuity contract is equal to the FPR amount for the contract without the MGDB ($8,000 and $10,000), and the total statutory reserves for each year are greater than the total FPR for the contract ($8,210 and $10,215). Just like the first holding of Rev. Rul. 2007-54, Rev. Rul. 2014-7 holds that, under I.R.C. § 807(d)(1), the amounts of the end-of-year life insurance reserves for the variable annuity contract in both Situation 1 and Situation 2 are the amounts of the tax reserve determined under I.R.C. § 807(d)(2) (i.e., $8,000 and $10,000 for 2012 and 2013, respectively, for Situation 1, and $8,155 and $10,165, respectively, for Situation 2).

The authorities cited and the analysis in Rev. Rul. 2014-7 are the same as those for the first holding in Rev. Rul. 2007-54 with one exception. The analysis in Rev. Rul. 2007-54 included a final sentence that Rev. Rul. 2014-7 omits. The sentence said: "The allocation of obligations between general account reserves and separate account reserves has no effect on the determination of the amount of IC's [the company's] life insurance reserves for Contract A under section 807(d)." Instead of including this sentence, Rev. Rul. 2014-7 concludes its analysis with a statement that the ruling provides guidance only with respect to the determination under I.R.C. § 807(d) of the amount of the life insurance reserves for a variable contract when some or all of the reserves are accounted for as part of a life insurance company's separate account reserves.

If one has an inclination to read more into the first holding of Rev. Rul. 2007-54, and also into its modified holding in Rev. Rul. 2014-7, one might wonder whether the ruling is aimed at answering the question of whether, for a variable contract, the comparison of the FPR to the net surrender value, and then to statutory reserves, is done based on the aggregate FPR for the contract or separately for FPR held in the general account and FPR held in the separate account. I have concluded that assuming Rev. Rul. 2014-7 is aimed at that question is reading too much into it. First, if that were the question to be answered by the ruling, the issue could have been stated a lot more clearly. Second, although the ruling cites both the comparison test of I.R.C. § 807(d)(1), which applies generally, and the separate accounting rules under I.R.C. § 817(c), which apply specifically for variable contracts, the analysis has no discussion of how these provisions might relate to each other. For example, the analysis does not say that the general rule that all FPR for a contract should be aggregated before compared to the net surrender value should override the separate accounting provision applicable specifically to variable contracts. Alternatively, the analysis does not explain that the specific separate accounting rule for income, exclusion, deduction, asset, reserve and other liability items that applies to variable contracts essentially requires that the separate account portions of a variable contract be treated as a contract that is issued as part of the separate account business, which under I.R.C. § 817 is accounted for as separate from the general account business. Third, the dollar amounts used in the facts do not allow the holding to illustrate clearly whether the I.R.C. § 807(d)(1) comparison should be done in the aggregate or separately for general and separate account reserves; it appears that the answer would be the same either way. Thus, the holding of Rev. Rul. 2014-7 merely illustrates that when the FPR is greater than the net surrender value, and less than the statutory reserves, the FPR amount is the life insurance reserve amount taken into account under I.R.C. § 807(d) (which is what I.R.C. § 807(d)(1) literally provides). ◂

END NOTES

1. 2014-9 I.R.B. 539 (Feb. 24, 2014).
2. 2007-2 C.B. 604.
3. For a discussion about how the company's share should be computed, see *Proration for Segregated Asset Accounts—How Is the Company's Share Computed?* 1 *Taxing Times*, Vol. 3, Issue 3 (September 2007); *Proration for Segregated Asset Accounts—Part Two*, 21 *Taxing Times*, Vol. 4, Issue 1 (February 2008).
4. 2007-2 C.B. 799.
5. In contrast, "revoked" describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling. It is my understanding that Rev. Rul. 2007-54 was not revoked because the IRS did not think the first holding was incorrect. Rev. Rul. 2007-54 was not revoked "in part" (i.e., the second holding) either.
6. On May 20, 2010, the IRS issued an IDD, LMSB-4-0510-015, which supersedes all prior directives regarding examining the DRD attributable to separate accounts of life insurance companies. The IDD affirms that Treas. Reg. § 1.801-8(e) sets forth a formula to be used in computing required interest at "another appropriate rate" for reserves accounted for as part of a separate account. It states that agents should consider raising the DRD issue if a life company's method for computing its company's share of investment income is inconsistent with I.R.C. § 812 and Treas. Reg. § 1.801-8(e), as illustrated by TAM 200038008 (Jun. 13, 2000) and TAM 200339049 (Aug. 20, 2002).

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