Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part IV: Insurance Tax Accounting Issues

By Peter H. Winslow (Moderator), John T. Adney, Sheryl Flum, Susan Hotine and Mark Smith[1]

Note from the Editors:

Welcome to the fourth and final part of a significant journey. At the outset, it was anticipated to be our most ambitious dialogue yet. Our goal was to explore the important and evolving topic of the extent to which the tax law defers to the NAIC in taxing life insurance companies.

Originally anticipated to be a three-part series, it was expanded to four parts due to the breadth of the topics to be covered under "Part III: Insurance Classification Tax Issues" and "Part IV: Insurance Tax Accounting Issues." "Part I: Tax Reserves" appeared in our June 2015 issue and "Part II: Policyholder Tax Issues" appeared in our October 2015 Issue and "Part III: Insurance Classification Tax Issues" appeared in our March 2016 issue.

We would like to thank our panel of highly experienced tax professionals. Peter Winslow of Scribner, Hall & Thompson developed the concept for this dialogue and volunteered to serve as moderator. Joining Peter was the core group of panelists who participated in each Part of the series: Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the IRS Chief Counsel's Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman LLP. Susan, John and Peter were all active in the legislative process "In the Beginning"—during the enactment of the Tax Reform Act of 1984. We are also grateful to the other panelists who contributed their expertise: Tim Branch with respect to "Part I: Tax Reserves," and Brian King with respect to "Part II: Policyholder Tax Issues."

In this Part IV, the panelists will address legal and accounting questions relating to insurance tax accounting issues, examining issues related to premium income, policyholder dividends, the accounting differences between life and nonlife companies, investment income, and the use of hedges, particularly hedges to offset the cost of variable annuity minimum guaranteed benefits.

We hope you enjoy the conversation!

Peter Winslow: This is the fourth, and final, installment of our extended dialogue on the issue of federal tax law's deference to insurance regulatory rules. We have covered in some depth the deference issues as they relate to tax reserves, policyholder tax issues, and insurance classification tax issues.[2] Now we will consider this question: to what extent does NAIC annual statement accounting govern for tax purposes for items other than insurance reserves? In this last dialogue we plan to talk about accounting for income items (premiums, investment income and hedging), as well as other expenses not included in insurance reserves. As in the prior dialogues, I will start with John Adney and Susan Hotine to give us an historical perspective on these issues. John, could you begin this discussion by describing how the 1959 Act and its interpretation dealt with the tax accounting for premiums?

PREMIUM INCOME

John Adney: Peter, "deference" is a good term to use in describing the 1959 Act's attitude on tax accounting issues for life insurers, and it also fairly characterizes the Code's approach in dealing with nonlife (part II) companies' tax accounting both before and after the 1984 enactment. As a general matter, under the 1959 Act premiums reported on a life insurer's annual statement were included in its gross income,[3] overturning the disregard of such amounts under the "net investment income" approach that had been used to tax life insurers since 1921. The great issue in this respect that was resolved in the waning years of the 1959 Act was the extent to which deferred and uncollected premiums[4] for life insurance were to be taken into account in life insurance reserves, assets, and gross premium income under the tax rules then in place. A diversity of views among five courts of appeals on how this question should be resolved led the Supreme Court to hear the case of *Commissioner v. Standard Life & Accident Insurance Company.*[5]

The principal statutory provision at issue in the *Standard Life* case was section 818(a) as it existed under the 1959 Act; its successor under current law is section 811(a), which is similar, but not identical, to its predecessor. Section 818(a) first required all computations under part I of Subchapter L to be made using an accrual method accounting or, as permitted under regulations, an accrual method combined with another method permitted for income tax purposes (but not the cash receipts and disbursements method). Then, significantly, it added: "Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."[6] The relationship of these two sentences was at the heart of *Standard Life* controversy.

The Supreme Court decided that the net amount of the deferred and uncollected premiums, i.e., the premiums net of loading, was to be taken into account in life insurance reserves, assets, and gross premium income. The court's rationale for recognizing this net amount in reserves was that this treatment had been "the consistent and unbroken practice since the inception of the federal income tax on life insurance companies" and also that this was required in the computation of reserves under state law.[7] Including the net amount of such "unpaid premiums" in reserves, however, posed the question of how far to carry the "fictional assumption" that the premiums had been paid.[8] The IRS position was not that the net amount should be excluded from reserves but, rather, that for consistency the unpaid premiums should be included in gross premium income and assets—yet to achieve this consistency, the IRS wanted to include in income and assets the full amount of the premiums, with no reduction for loading. This lack of symmetry troubled the court, but so did the taxpayer's argument that none of such premiums should be included in income and assets, presumably on the ground that accrual accounting would not require it.

To resolve the conflicting views and "decide the scope to be given to a fictional assumption,"[9] the Supreme Court looked to the second sentence of former section 818(a), invoking the role of the NAIC annual statement. The annual statement accounting for deferred and uncollected premiums, which the court acknowledged had no counterpart in accrual accounting, required the net amount of the premiums to be included in income and assets. Under section 818(a), according to the court's opinion, "rejection of the NAIC approach would be justified only if it were found inconsistent with the dictates of accrual accounting," which the court found not to be the case.[10] The court thus concluded that deference to the NAIC's treatment of the unpaid premiums not only was mandated by the statute but also provided a practical solution to the conundrum.

This was not the end of the story for deferred and uncollected premiums because of a change made by the 1984 Act, but the general guidance provided in the *Standard Life* opinion on the relationship of the accrual method requirement and the role of annual statement accounting under today's section 811(a), at least for insurance reserves, remains valid. A more recent decision involving a part I taxpayer under the 1959 Act that cited to the *Standard Life* formulation is that of *Time Insurance Company v. Commissioner*.[11] In that case, the insurer deducted medical insurance claim reserves that were determined by assigned loss "incurred dates" and a claim lag allowance in accordance with state law and NAIC requirements. The Tax Court sustained the deductions over IRS objection, reasoning that the insurer's claim reserve computations following NAIC rules were not inconsistent with accrual accounting because such computations were not recognized in accrual accounting. The court viewed the NAIC rules as controlling in this instance since the Code and regulations were otherwise silent on the matter.

Peter: You are right that *Standard Life* is not the end of the story for deferred and uncollected premiums. Susan, what is the next chapter in the story? How did Congress address this accounting issue for premiums in the 1984 Act?

Susan Hotine: John is right. Section 811(a) is very much like its predecessor under the 1959 Act, section 818(a). Like its predecessor, section 811(a) generally requires accrual accounting (or, to the extent provided under regulations, a combination of accrual and another accounting method). The difference from its predecessor is in the introductory clause to the flush language that calls for computations to be made in a manner consistent with the requirements of the NAIC annual statement. Whereas old section 818(a) said that accounting should be consistent with annual statement accounting "[e]xcept as provided in the preceding sentence [requiring accrual accounting]," current section 811(a) says the same thing, but "[t]o the extent not inconsistent with the preceding sentence or any other provision of this part." The legislative history explains the purpose of this change as making it clear that accounting methods for state regulatory purposes apply only to the extent they are not inconsistent with Federal tax accounting rules; as reinforcing the primacy of the Federal tax rules and not imposing a new method of accounting on life insurance companies.[12]

Also, with the 1984 Act, a new accounting rule was adopted that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income.[13] Because deferred and uncollected premiums do not accrue until paid, the reserves related to those premiums may not be recognized until the premiums are taken into income. This effectively reverses the holding of the *Standard Life* case.

To the extent the *Standard Life* case held that in some instances accounting for premium income need not follow standard tax accrual accounting rules, but should be consistent with NAIC annual statement accounting to offset reserve recognition rules, the adoption of section 811(c)(1) eliminates the need for such a conclusion by altering the reserve recognition rules for tax purposes. Thus, the current-law accounting provisions adopted under the 1984 Act have to be interpreted as cutting back on the amount of deference to be shown to NAIC annual statement accounting for tax purposes.

Peter: Is it fair to say, then, that what Congress effectively did in the 1984 Act was to change the accounting for premium income, delinking it from NAIC annual statement accounting, but at the same time carrying over from prior law the deference to annual statement accounting for insurance reserves that the Supreme Court recognized in *Standard Life*?

Instead of continuing a deduction for policyholder dividends based on changes in a policyholder dividends reserve, the 1984 Act adopted a rule allowing a deduction only for policyholder dividends paid or accrued during the taxable year.

Susan: I agree that Congress "delinked" accounting for premium income from NAIC annual statement accounting under the Supreme Court's analysis in *Standard Life*, but at the same time the specific deference to annual statement accounting for insurance reserves that the court recognized in has been trumped by the rule in section 811(c)(1). Thus, the call for tax computations to be consistent with NAIC annual statement accounting is premised on such consistency not being inconsistent with the general accrual accounting rule "or any other provision" of Part I. I think I would say that Congress carried over from prior law the deference to annual statement accounting for insurance reserves that the Supreme Court recognized in *Standard Life* to the extent it did not adopt specific tax rules or restrictions (e.g., tax reserve rules under section 807(d)), and the computational restriction against reserving for excess interest guaranteed beyond the end of the taxable year under section 811(d)).

POLICYHOLDER DIVIDENDS

Peter: Let's turn to another accounting issue—policyholder dividends. Where were we on tax accounting for policyholder dividends under prior law?

John: As a general matter, the 1959 Act allowed a deduction for policyholder dividends shown on the annual statement, including the reserve for dividends declared before year-end and payable in the following year.[14] The deduction for the reserved amount departed from accrual accounting precepts, of course, and followed the NAIC statement's approach. The ability of an insurer to benefit from this deduction varied based on the "phase" in which it was taxed under the 1959 law, but that is another and much more complex story.

Peter: Susan, I think we have another chapter in the story for policyholder dividends too. Will you outline for us the changes made in life insurance company tax accounting by the 1984 Act for policyholder dividends?

Susan: Instead of continuing a deduction for policyholder dividends based on changes in a policyholder dividends reserve, the 1984 Act adopted a rule allowing a deduction only for policyholder dividends paid or accrued during the taxable year.[15] While prior law followed annual statement accounting for policyholder dividends, current law does not. As part of the transition rules of the 1984 Act, companies were given a "fresh start" with respect to the policyholder dividends deduction. That is, the change from reserve accounting to accrual accounting was not treated as a change in method of accounting requiring a section 481 adjustment to eliminate what would result in a double deduction of certain dividend amounts. Interestingly, soon after the enactment of the 1984 Act, Congress became aware of the fact that companies began changing their dividend declaration practices. Instead of declaring a policyholder dividend amount at the end of a year to be payable on policy anniversaries during the following year, companies began guaranteeing policy dividends on termination, or changing the dividend payment date by making the dividends available upon declaration. Because it was viewed that such changes in business practices restored the company in part to the position it enjoyed under prior law, Congress enacted provisions under the Tax Reform Act of 1986 to eliminate what was perceived as a double benefit of accelerating policyholder dividend deductions by a change in business practices and the fresh-start benefit otherwise made available.[16]

Sheryl Flum: To be deductible under the current tax standard, life company policyholder dividends must be "paid or accrued" during the taxable year.[17] In two fairly recent cases, the IRS argued that policyholder dividends can't be deducted in the year immediately preceding the year of payment.[18] In *MassMutual*, the policyholder dividends at issue were guaranteed in the aggregate, and the court allowed the accrual and, thus, the deduction in the earlier tax year. In *New York Life*, the policyholder dividends at issue were either (1) credited in December and paid in January or (2) paid at termination of the life insurance policy; the taxpayer was unsuccessful in convincing the court that accrual had occurred in the earlier tax year.

The taxpayers in *MassMutual* and *New York Life* did **not** argue that statutory accounting treatment for policyholder dividend accruals would control the tax deductibility result. Indeed, both taxpayers agreed with the IRS (or at least did not ultimately contest) that the "all events test" and the economic performance rules would apply to their policyholder dividends deductions. State regulatory treatment was an enhancing—yet not decisive—fact in *MassMutual*, as the Federal Circuit noted that "… *MassMutual* had informed state regulators of these dividends, the state regulators approved the dividends, and there was evidence that the regulators had authority to enforce the dividend guarantees if that were necessary."[19]

So the themes of deference and statutory accounting treatment did not come into play as part of the current life company policyholder dividend controversies—although state regulators' involvement in the dividend process was acknowledged by the court in MassMutual.

ACCOUNTING DIFFERENCES BETWEEN LIFE AND NONLIFE COMPANIES

Peter: John, you commented that deference to the NAIC also describes the Code's approach to dealing with tax accounting for nonlife or part II companies. How is that the case?

John: As you noted, Peter, in your excellent article on the section 807(d) treatment of stochastic reserves that appears in the last issue of *Taxing Times*,[20] part II of Subchapter L has been construed by the courts as giving broad deference to the NAIC. Use of the annual statement accounting for items of income and expense of property and casualty insurers is hard-wired into the rules of section 832, a circumstance that long pre-dated the enactments of the 1980s and continues today. Section 832(b)(1)(A) and (6), dealing respectively with the definitions of the gross income and the expenses incurred, expressly require these amounts to be determined for part II companies based on the NAIC annual statement. In cases challenging various loss reserve deductions that adhered to the amounts shown on the insurers' annual statements, the courts have enforced the statutory requirement. As the Court of Appeals for the Seventh Circuit observed in the *Sears* case, "State insurance commissioners' preferences about reserves thus are not some intrusion on federal tax policy; using their annual statement is federal tax law."[21]

Mark Smith: Absolutely true, and that has certainly been the trend in recent litigated cases. In Part I of the dialogue, we talked about several cases in which the IRS unsuccessfully challenged taxpayers' treatment of various items that for tax purposes were accounted for consistent with the annual statements the companies filed. For example, in the *State Farm* case,[22] the Seventh Circuit deferred to annual statement principles to conclude that a taxpayer must include compensatory damages in unpaid losses for purposes of section 832(b)(5). Most recently, in the *Acuity* case,[23] the Tax Court disagreed with the IRS that a company's annual statement reserves were too high and should not be used for tax purposes. And, in the *R.V.I.* case,[24] the Tax Court relied heavily on the characterization of residual value insurance policies for state regulatory purposes to conclude the policies constituted insurance in the commonly accepted sense.

That is not to say that there is a single overarching theory of deference in these cases. In fact, one could take a different lesson from each. For example, one could reasonably read *State Farm* to defer to the annual statement characterization to determine the character of losses that are included in "unpaid losses." One could reasonably read the *Acuity* case as primarily involving valuation, and respecting the thoroughness with which the statutory reserves in that case were determined. And, one could reasonably think of the *R.V.I.* case as not involving reserves at all, but rather considering the statutory treatment of an arrangement in order to decide whether the arrangement constituted insurance in the commonly accepted sense. To John's point and the quote from *Sears*, I think the differences in these cases broaden, rather than narrow, the deference that is inherent in these rules.

Peter: John and Mark, I'm glad you noted the deference to annual statement accounting for nonlife insurance companies, and particularly appreciate John's kind comment on my article on stochastic reserves. It so happens my "*Can You Believe It*?" column in that same issue of *Taxing Times*[25] also bears on this question. In that column I point out that nonlife companies essentially get to use annual statement reserve accounting for three items—experience-rated refunds on group insurance, guaranty fund assessments and loss adjustment expenses—and life insurance companies do not. Let's take these items one at a time and briefly tell our readers why life companies can't use annual statement accounting for them. John, tell us about experience-rated refunds.

John: As Susan pointed out a little earlier, the 1984 Act abandoned basing the deduction allowed to a life company for policyholder dividends on the change in the annual statement reserve for the dividends. In 1984, Congress opted instead to allow the deduction only for dividends paid or accrued during the taxable year. At the same time, the Act defined policyholder dividends to include experience-rated refunds, which it defined as "any refund or credit based on the experience of the contract or group involved."[26] This broadened the scope of the policyholder dividend definition that had been used under the 1959 law, which referred to the experience of the company and the discretion of management in characterizing an amount as a dividend. Hence, under the tax law today, and without regard to its treatment on the NAIC annual statement, an experience refund is deductible only if it meets the "paid or accrued during the taxable year" standard.

Peter: Mark, what about guaranty fund assessments? Why don't NAIC accounting rules govern for life companies?

Mark: The general rule for guaranty fund assessments under SSAP 35 is that they are charged to expense when an insolvency giving rise to an anticipated assessment takes place. So far, so good.

For tax purposes, the general rule in Subchapter L that begins with the annual statement treatment of an item sometimes yields when a more specific rule in the Code prescribes a different treatment. Several specific tax rules compete in the case of guaranty fund assessments. For example, is the assessment accounted for as a tax? SSAP 35 applies to "taxes, licenses, and fees." For tax purposes, however, the Court of Federal Claims has concluded that the assessments are not taxes within the meaning of section 164.[27] Is the assessment required to be capitalized under section 263 of the Code? Regulations under that section[28] presume that payments are deductible unless specifically enumerated, and guaranty fund assessments are not so enumerated. Is the assessment deductible before it is paid? Possibly so, if it can be characterized as a reserve or if there is an argument that economic performance occurs before payment. In the *Acuity* case, the IRS originally asserted that the economic performance requirement was not satisfied before payment of a guaranty fund assessment, but the IRS conceded that issue before trial. What about treating it as a reserve? A critical reader will ask whether such an amount can be included in tax reserves where it wasn't accounted for as a reserve for annual statement purposes.

The point here is not that we can resolve the treatment of guaranty fund assessments in this dialogue. Rather, the reader should be aware that several specific tax rules bear on the issue, and as a result the likelihood the IRS or a court would defer to SSAP 35 for guaranty fund assessments is correspondingly diminished. The September 2006 issue of *Taxing Times* has a very helpful article discussing the tax accounting for guaranty fund assessments.[29]

John: Mark, an assessment's treatment as an allowable tax reserve would also depend on the rule in section 811(c)(1). As Susan described earlier, in adding that rule to the Code, Congress made clear that for a reserve to be recognized for tax purposes, the premiums or other consideration funding it must be included in gross income. So, for a reserve deduction to be allowed, it would be necessary to distinguish that rule or else contend that it was somehow satisfied.

Peter: Susan, there is some controversy about the treatment of loss adjustment expenses for life companies. Can you shed some light on this question and explain why the IRS takes the position that life companies can't deduct these types of expenses on a reserve basis as required by annual statement accounting under SSAP No. 55?

Susan: When the 1984 Act was enacted, it was generally understood that loss adjustment expenses (LAE) of life insurance companies were deductible when paid or accrued and could not be deducted on a reserve basis as allowed for nonlife insurance companies under section 832(b)(6). However, with the enactment of the Tax Reform Act of 1986, the provisions to discount unpaid losses under section 846 apply to both life and nonlife insurance companies, except where there are specific tax reserve rules for unpaid losses under section 807(d). The last sentence of flush language of section 807(c) says that, for purposes of determining the reserve for unpaid losses and benefit payments, "the amount of unpaid losses (other than on life insurance contracts) shall be the amount of the discounted unpaid losses as defined in section 846." Under section 846(a), the amount of discounted unpaid losses is based on "undiscounted unpaid losses," which means the unpaid losses shown on the annual statement filed by the company, and which includes any LAE shown on the annual statement.[31]

In explaining discounting of unpaid losses, the legislative history on the discounting of unpaid losses is consistent with the statutory language, saying that LAE are to be treated as unpaid losses (and discounted) and not to be included in the amount of expenses unpaid under section 832(b)(6).[32] However, when the Tax Reform Act of 1986 went to conference and the conference committee adopted the Senate's provisions for discounting unpaid losses, the committee clarified that, although life insurance companies were subject to the same unpaid loss discounting rules, life insurance companies "may not deduct loss adjustment expenses that do not meet the all-events test applicable under sec. 461 of the Code."[33] The legislative history continues to explain that it is not intended that noncancellable accident and health business subject to tax reserves rules under section 807(d) be subject to section 846 discounting, and that life insurance companies be permitted to deduct LAE by virtue of the application of section 846 discounting to cancellable accident and health business. Based on this clarification in the Conference Report, the IRS takes the position that life insurance companies cannot include LAE in unpaid losses.

It should be pointed out that, although the Conference Report included this "clarification," the Conference Committee made no changes to the statutory language. By the same token, it can be argued that the statutory language regarding a life company's use of section 846 discounting for unpaid losses and the inclusion of LAE in unpaid losses is not ambiguous on its face. The IRS' reliance on the legislative history might be viewed as inconsistent with the Supreme Court's more recently stated positions that legislative history is relevant only to help construe an ambiguous statute.[34]

Peter: So, it seems unclear whether LAE is deductible by life companies following NAIC reserve accounting at least for LAE on cancellable A&H products.

INVESTMENT INCOME

Peter: Let's shift gears and talk about investment income and the role of NAIC annual statement accounting. The Code has an interesting special rule that is applicable only to life insurance companies. Section 811(b) says that a life company is entitled to accrue original issue discount (OID) and bond premium in accordance with the method regularly employed by the company if that method is reasonable. This has been interpreted to permit life companies to follow their annual statement accrual method for OID and bond premium and not use the detailed rules for these items generally applicable to other taxpayers. This is usually, but not always, a better answer; it's certainly a simpler approach.

Mark, does this special OID income accrual rule provide authority for the IRS not to require taxpayers to accrue OID on impaired bonds even if there is doubt as to its collection?

Mark: Yes, it does. According to IRS, the OID rules require that a taxpayer continue to accrue Original Issue Discount into income, even when there is doubt as to the collectability of amounts due on the underlying debt.[35] This position is particularly harsh, because it requires recognition of income that likely will never be collected. Taxpayers have criticized the position, and it would operate as a particular hardship to insurance companies, which historically hold significant corporate debt. Fortunately, in the case of life insurance companies, the IRS has recognized that section 811(b) deference to "the method regularly employed by the company" provides authority to reach the result that more clearly reflects income in the case of OID accrual on impaired debt. In a 1993 Field Service Advice,[36] the National Office advised the team examining a life insurance company that accrual was not required in a situation where the appraised value of the collateral was less than the loan at issue, provided the company established that the statutory accounting treatment was not to accrue.

Peter: Speaking of impaired investments, there have been significant recent developments on the question of deferral to NAIC accounting for bad debts.

Mark: Yes, there have. The tax law allows a deduction for debt that becomes worthless during the year. Regulations provide circumstances where a bank "or other corporation" that is similarly regulated for solvency charges off a debt in whole or in part.[37] Under those regulations, a debt is conclusively presumed to be worthless to the extent charged off under established regulatory standards subject to subsequent written regulatory confirmation of the charge-off on audit. The operation of those regulations is straightforward for banks, but in some cases generated controversy for insurance companies. Early on, some examiners, for example, questioned whether the methodology in the regulations applied to insurance companies, or whether the application of SSAP 43R met the regulation's requirements of a charge off, or how much of a charge off was credit-related and therefore deductible.

In response to industry requests and a lengthy dialogue, the IRS issued an Industry Director's Directive[38] that set forth the terms and conditions under which this conclusive presumption of worthlessness would apply. For example, the Directive specifically referred to credit-related impairments under SSAP 43R, and provided an entire regime for implementing the regulation, including a consistency requirement, a certification statement, instructions for determining the amount of worthlessness and adjusted basis, and mechanics of a section 481 adjustment.

We would identify this as an example of "deference" in this dialogue, and I think many taxpayers, advisors, and IRS personnel also would think of it as an example of good government. Stat-tax conformity in accounting for worthless or partially worthless debt produces a clear reflection of income and dramatically reduces time-consuming controversies in Examination.

One interesting footnote to this story is that the IRS subsequently published a Notice[39] to the effect it was taking a fresh look at the regulation on which the Directive is based. Many in the industry hope the IRS will use the opportunity to make improvements to the regulation, such as expanding the regulations to apply to foreign-regulated companies, and addressing the treatment of post-charge off accretions and recoveries.

Peter: The industry coalition that worked with the IRS on this bad debt Directive has submitted comprehensive recommendations for these regulations to improve the IRS' treatment of impaired assets.

Sheryl: I'm not sure I have such high hopes that the IRS is planning on expanding the application of the regulation. I think the IRS' purpose in reconsidering the regulation has more to do with their reluctance to rely on state regulators. The idea behind allowing regulated companies (i.e., banks and insurance companies) to take a tax deduction for debts their regulator required them to write off was to ensure that there would be no cash tax expense incurred that would diminish the impact of the write-off. The regulatory concern is consumer protection. Banks and insurance companies need to have liquidity to cover customer needs. The Code, on the other hand, does not generally consider taxpayer liquidity needs. It's possible that the IRS is reconsidering whether to follow statutory accounting in these situations.

HEDGES

Peter: Your discussion of the IDD for bad debts leads us naturally to another important recent IDD dealing with life insurance company hedging for variable annuities. Mark, is there any role for annual statement accounting for hedges in determining the tax liability of life insurance companies? Tell us about the hedging IDD.

Mark: That's a great topic, and possibly the most important subject matter in this whole area of deference in the past ten years.

The tax laws for recognizing gains or losses on the sales and exchanges of assets, and the character of those gains or losses, are complex. In general, gains and losses are recognized for tax purposes when they are "realized" (that is, when the underlying instruments are sold or the position is closed), and capital losses are deductible only to the extent of capital gains, or are carried back or over. If the positions are hedges, the tax law attempts to match the timing and character of gains and losses to the timing of gains and losses relating to the item being hedged.

> The VA hedge IDD carefully threads a very fine needle, and does so with an artful and appropriate deference to statutory accounting.

What happens when a company hedges its obligations to policyholders with respect to guaranteed minimum benefits under variable annuity contracts? What is being hedged, the reference assets or the obligations to policyholders? What is the nature of the gains and losses? Are they capital? Ordinary? When and how should the gains or losses be measured for tax purposes? On a mark-to-market basis? A realization basis? This is an area where the development of products and guarantees outpaced the ability of existing tax guidance to produce sensible answers. After the financial downturn in 2008, many companies were left with enormous losses on assets that they held, and potentially enormous mismatches in income and deduction as a result of timing and character differences in the accounting for hedges and the reserve deductions that accounted for obligations to policyholders.

Like the process for the IDD for bad debts that we just talked about, the process for the IDD for variable annuity hedging[40] began with an industry request that the IRS address these issues and provide sensible guidance to clearly reflect income and minimize controversy in Examination. The outcome of that process was an IDD that had several very helpful features: (1) the identification of GMxB obligations and hedges as ordinary; (2) the use of mark-to-market value accounting, based on the mark-to-market valuation that applies for statutory accounting purposes; and (3) a method of accounting for hedge gains and losses that, at least to a degree, attempts to match those gains and losses to the reserves with respect to the company's corresponding obligations under the guarantees. Less helpful was a limitation that the IDD applied only to contracts that were issued before Dec. 31, 2009. A full discussion of the IDD is beyond the scope of our dialogue, but the IDD was the subject of a webinar that was sponsored by the Taxation Section, and also was the subject of a number of thoughtful articles in *Taxing Times*.[41]

The VA hedge IDD carefully threads a very fine needle, and does so with an artful and appropriate deference to statutory accounting. First, as a matter of valuation, the Directive appropriately looks to mark-to-market values that are assigned for statutory purposes, rather than expend resources trying to discern a different, independent valuation to apply only for tax purposes. Second, as a matter of matching, the Directive references net tax deductions for the guaranteed minimum benefits which, in turn, are a function of the company's tax reserves. To the extent the starting point for determining those tax reserves is statutory reserves, the Directive assigns an important role to statutory accounting (or at least builds on the deference already accorded to CRVM and CARVM). None of this defers to the statutory accounting for the hedge gains and losses directly. Rather, it relies on specific elements of statutory accounting to achieve reasonable timing and character for tax purposes.

Peter: It is true that the VA hedge IDD defers to statutory accounting in several important ways, particularly in the reliance on annual statement valuation of the derivatives, but in general hedging is one area where deference to the annual statement seems less useful. Hedge accounting for annual statement purposes currently requires the hedge to be highly effective,[42] which is almost impossible to achieve for VA hedges. Yet, tax hedge accounting is required because all that is needed to qualify as a tax hedge is for the derivative to manage risk with respect to an ordinary liability. On the other hand, tax hedge accounting is not available for hedges of capital assets, but hedge accounting is available for statutory purposes for highly effective asset hedges.

Although difficult to achieve for liability hedges, a highly effective hedge is not as difficult for asset hedges. So, both the availability of tax hedge accounting and the tax hedge accounting method frequently do not rely on annual statement accounting.

Mark: Broadly, this might be a lesson of this last part of the dialogue. That is, with a regime that begins in statutory accounting and then asks what more specific tax rules might trump, it is important to step back periodically and ask whether the overall accounting for a particular transaction or class of transactions makes sense, and also ask whether Congress intended that particular item to be based on statutory accounting or generally applicable Code provisions.

Peter: I think an appropriate end to these dialogues would be a summary of what we have collectively learned from our discussion as to the role of regulatory guidance in interpreting the tax law. We have spent hours over the last year and a half discussing this deference issue as it relates to almost every aspect of life insurance company and policyholder taxation and I am going to try the impossible and sum up everything we have discussed on company tax issues in a lightening round of about one minute.

For the classification issues concerning whether the company is taxed as an insurance company, whether the product is considered insurance and whether premiums are subject to the DAC tax, we have all accepted Sheryl's helpful phrase that NAIC and state regulators' classifications are "helpful but not sufficient." An exception to this general observation is the 50 percent-reserve-ratio test that determines whether an insurance company is a life insurance company for tax purposes. There we have a special tax test that does not depend on NAIC or state definitions of a life insurance company, although the test itself does use statutory reserves.

For tax reserves, we have considerably more binding deference. In general, we have discovered that statutory reserves are used as tax reserves, except where the Internal Revenue Code requires that adjustments be made. And, with just a few exceptions (for example, deficiency reserves and interest rates) the required adjustments are based on NAIC guidance (tax reserve method) or majority state requirements (mortality and morbidity assumptions).

The deference issue as it relates to tax accounting for non-reserve items discussed in this fourth part of our dialogue is mixed bag. In general, gain from operations items, such as premiums, policyholder dividends and guaranty fund assessments, are determined on a tax accrual basis, rather than following annual statement accounting. A possible exception to this may be loss adjustment expenses for cancellable health policies. For investment income, statutory accounting generally can apply for OID and bond premium accruals and maybe impairments of some investments, but only those that qualify for bad debt treatment (for example, not corporate bonds) and only if certain procedural hoops are jumped through. Tax hedge accounting stands on its own and is not governed by statutory accounting.

John, are you up to the challenge to sum up in a lightening round in one minute what we have concluded for the deference issues on policyholder tax issues?

John: I've never completed anything in one minute, Peter, but here goes. If deference refers to congressional reliance on state law and state regulatory practices in the application of the tax statutes, that deference is significant but is far from complete in the product tax area. Thus, Congress built section 7702, section 101(f) before it, and later section 7702A on the structure of state regulation, including the requirement that a contract be treated as life insurance under the law of the jurisdiction in which it is issued in order to be eligible for tax treatment as life insurance. Also, the statutes use the concept of a premium, both net and gross, to define the limits of a life insurance contract's permitted investment orientation, but the definition of this premium must be drawn from state law and associated actuarial practice and tradition. At the same time, however, the tax law prescribes its own very specific rules regarding the calculation of the limiting premiums to implement the objective of constraining investment orientation. Further, as Part II of our dialogue discussed, section 7702's use of the term "cash surrender value" has been the subject of on-going tax regulatory guidance even though it is premised on concepts in state law. In the case of annuities, the income tax regulations specifically refer to the customary practice of insurance companies as a defining touchstone. That said, Congress, the courts, and the IRS have all added to this definition, limiting the benefit of tax deferral to contracts that liquidate principal and are owned by or for individuals, and limiting the duration of this benefit following an owner's death.

The tax law interacts with state law governing long-term care insurance and accelerated death benefits in similar fashion. The safe harbor rules for long-term care insurance contracts in section 7702B rely on state law to identify the eligible contracts, but then set forth a number of conditions for entering the harbor. These conditions sometimes reference state law—such as by requiring that the contracts be guaranteed renewable and by "federalizing" an impressive list of consumer protections that appear in the NAIC's model regulation on the subject—and sometimes they impose their own restrictions, such as barring the presence of a cash value and allowing returns of premiums only at death or surrender. And for accelerated death benefits, the tax law accords with state-based rules allowing life insurance death benefits to be paid where the insured is terminally or chronically ill, but it imposes additional requirements to assure, among other things, the existence of the claimed illness.

Peter: You are hopeless, John. That was well over one minute—but worth it. John and Susan, you both have been around since the 1984 Act was enacted. Do you think the evolution of the tax law over the last 30 years has been consistent with what Congress intended and the insurance industry envisioned in 1984?

Susan: All in all, yes, I think that the tax law has evolved over the last 30 years as Congress intended in 1984. Although some tax lawyers today read the current Part I of Subchapter L as though it were a brand new statute beginning in 1984, this is not the case. For those who are familiar with the provisions of prior law, it is obvious that the vast majority of the statutory language used in current law is the same as that of prior law. Thus, the legislative history of the current provisions reminds us of the rule of statutory construction that provisions of current law that are based on prior law should be interpreted in a manner consistent with prior law, and says specifically "that, in the absence of contrary guidance in the committee reports, the regulations, rulings, and case law under existing [i.e., prior] law may serve as interpretative guides to the new [i.e., current] provisions."[43]

The current law provisions adopted in 1984 simplified the tax structure for life insurance companies by eliminating the prior-law three-phase structure and providing a single-phase structure designed by reference to a stock life insurance company to more closely resemble the general structure for corporate income taxation; and the elimination of the three-phase structure eliminated many prior-law tax issues that arose from that structure. The use of reinsurance to manipulate a company's taxable income was discouraged by the adoption of section 845. Special life insurance company non-economic deductions under prior law were eliminated and the taxable income computation for life insurance companies became more in line with that of non-insurance corporations. Finally, rather than having a company's tax reserves based on its statutory reserves as under prior law (which allowed an individual company leeway to report smaller or larger reserves depending on its surplus needs as long as the reserves met the regulator's minimum reserve requirements), specific rules for computing tax reserves not only tend to provide a better economic estimate of the company's insurance liabilities than what might be reflected as reserves on its annual statement, but also provide more uniformity in the amount of reserves that can be claimed as liabilities for similar insurance benefits by companies.

I think these were all goals for the provisions adopted by Congress in 1984 and were all more or less accomplished. On the other hand, Congress left some things the same. For example, the tax rules for insurance companies continue to be set apart from the rest of the Code in Subchapter L, with general tax rules applicable to non-insurance taxpayers incorporated by cross reference. Also, the current life insurance provisions still refer to annual statement accounting (section 811(a)) and the reserve methods prescribed by the National Association of Insurance Commissioners (section 807(d)(2)). Thus, I have not been surprised when courts have overruled an IRS position that perhaps is based more on general tax principles in favor of a taxpayer insurance company's position that is consistent with accounting and reserve principles prescribed by the NAIC. I do not think that such results are inconsistent with what Congress intended in 1984.

John: I not only agree, Susan, but I must marvel at the resiliency of what was done in the 1984 law. Part I of subchapter L as revised in 1984 has endured longer than any of its counterparts enacted in 1909, 1913, 1921, 1942, and 1959. There have been amendments, certainly, such as the technical corrections made in 1986, the 1987 addition of the section 846 AFR to the interest rate used for tax reserves in section 807(d), the advent of the DAC tax in 1990, and the repeal of section 809 and effective elimination of the left-over phase three tax during the last decade. But the basic effort to remove non-economic deductions and generally rationalize the tax treatment of life insurers remains in effect today. Indeed, the only criticism I would offer goes not to the rules enacted in 1984 but to the 1987 amendment, which introduced what in my view is the questionable use of the loss reserve discount rate to determine the deductible amount of life insurance reserves.

On the product tax side, I believe the 1984 enactment of section 7702 has worked as Congress intended it and largely as the industry envisioned. The major surprise to the industry likely resides in the historic drop in interest rates, which has made section 7702 more difficult to live with in view of its four percent and six percent minimum rate assumptions. To be sure, many companies have had to struggle with the administration of this statute in light of compliance system and personnel errors that have resulted in its inadvertent violation, but the IRS has stepped up to put programs in place to enable the cure of these violations. The greater challenge to companies, in my experience, has come with the enactment, in TAMRA in 1988, of the so-called reasonable mortality and expense limitations in section 7702 and of the companion rules of section 7702A rather than with the action Congress took in 1984.

Peter: To sum up what I am hearing, we seem to agree that in general Congress intended in 1984 to retain considerable deference to insurance accounting principles in the tax law, particularly with respect to insurance reserves. And, that deference has worked pretty well and as Congress intended. Although the IRS has frequently resisted this deference where it has perceived a conflict with the general tax law goal to protect the fisc, the IRS' push back generally has been rebuffed by the courts, most recently in *American Financial*. Mark, can you sum up for us where you think the IRS is currently on this deference issue. Has its thinking evolved since *American Financial*?

Mark: The lack of published guidance since *American Financial* (and, for that matter, since *State Farm*, *Acuity*, *Cigna*, and Notice 2010-29) makes it hard to tell exactly where the IRS is on deference issues as they relate to insurance reserves. I think, though, that it would be incorrect to assume there ever has been a single overall theory of "deference" on the part of the IRS or, for that matter, taxpayers.

Issues come up one at a time, and both the IRS and taxpayers evaluate whether insurance accounting principles control, or whether instead Federal income tax principles should trump, on a case by case basis. That has always been the case. Based on the cases the IRS has lost in the past decade (particularly *American Financial*), it is inevitable that the pendulum would swing in favor of deference. But by no means will that be the product of an evolving, over-arching theory of deference. Rather, it will be the product of an ad hoc, case-specific assessment of one issue at a time based on existing authorities and (hopefully) a priority that whatever position is taken should clearly reflect income.

An interesting test of this will be the IRS approach to Life PBR, guidance on which is included in the current Priority Guidance Plan. I think most of us believe and hope that the IRS will show considerable deference to insurance accounting principles as those provide the clearest reflection of income and the fairest measurement of life insurance reserves. Enough tax issues are implicated that we may very well see the most robust analysis of various issues under section 807 that we've seen in many years. It seems to me that the most logical move for the IRS would be to defer to insurance accounting principles to the maximum extent it believes that it can. As discussed in prior dialogues, this would be the most administrable approach and, ultimately, would best reflect income.

Sheryl: As the IRS has not acquiesced in any of the cases they've lost regarding deference, it may be a bit of an overstatement to say that the IRS now favors deference even on an issue-by-issue basis. In providing guidance for Life PBR, the IRS could take the same approach used for the implementation of AG 43. That is, they might provide that the net premium reserve portion of VM-20 can be used for federal tax purposes, and remain silent on everything else. Who knows? We'll probably still be talking about deference in the abstract five years from now.

Peter: Now, John, I would like you to give Congress some advice if it ever gets around to comprehensive tax reform. To what extent should Congress defer to NAIC reserve and accounting rules in amending Subchapter L of the Code for life insurance companies? What is the most important area where the tax law should defer to statutory accounting?

John: I would urge greater deference to the NAIC in the reserve rules of the future in two respects. First, work I have done over the past year examining the rationale underlying the interest rate formula established in the Standard Valuation Law in 1980 has convinced me of the formula's soundness for use in section 807(d). That formula was incorporated into the federally prescribed reserve rules in 1984, and it was a mistake to muddy the waters by importing the section 846 rate into the mix. Second, with the advent of principles-based reserves, Congress is being accorded an historic opportunity to accomplish a long-standing goal of tax policy where life insurers are concerned. Where the deterministic or stochastic reserves prevail for a type of contract, those reserves are about as close to economic reserves as can reasonably be achieved today, and so they should be tax deductible reserves.

Peter: With the talent and experience we have on the panel, we could go on for much longer on these issues, but I think I can hear the *Taxing Times* editors screaming that we have already exceeded our page limitation.

I want to sincerely thank our distinguished panelists for their participation in this four-part dialogue. I hope the *Taxing Times* readers have found it useful. NAIC annual statement accounting is still alive and well as a guide to life insurance company taxation! But, as Mark notes, maybe only on a case-by-case basis. ■

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END NOTES

[1] **Disclaimer:** The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of any author's firm.

[2] Peter Winslow, et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part I: Tax Reserves," *Taxing Times*, Vol. 11, Issue 2, at 22 (June 2015); Peter Winslow, et al., "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part II: Policyholder Tax Issues," *Taxing Times*, Vol. 11, Issue 3, at 13 (October 2015); Peter Winslow, et al., "Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to NAIC: Part III: Insurance Classification Tax Issues," *Taxing Times*, Vol. 12, Issue 1, at 13 (March 2016).

[3] Former section 809(c)(1).

[4] A deferred premium is an amount due in the future, i.e., between the annual statement (and tax) year-end and the contract anniversary. An uncollected premium is one due but unpaid at year-end, i.e., during a contract's grace period.

[5] 433 U.S. 148 (1977).

[6] The 1984 legislation changed the lead-in phrase of the quoted language to read: "To the extent not inconsistent with the preceding sentence or any other provision of [part I] … "

[7] 433 U.S. at 157.

[8] *Id.* at 158.

[9] *Id.* at 159.

[10] *Id.* at 162.

[11] 86 T.C. 298 (1986).

[12] Staff of the J. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 621 ("1984 Blue Book").

[13] Section 811(c)(1).

[14] Former section 811(b).

[15] Section 808(c).

[16] Section 808(f). *See* Staff of the J. Comm. on Tax'n, 99th Cong., *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation*, at 83–85.

[17] Section 808(c). Compare this with the nonlife policyholder dividend deduction standard, which is "paid or declared." Section 832(c)(11).

[18] *Mass. Mut. Life Ins. Co. v. United States*, 782 F.3d 1354 (Fed. Cir. 2015) ("MassMutual") (certain dividends guaranteed in the aggregate held deductible in the year guaranteed rather than the year paid); *N.Y. Life Ins. Co. v. United States*, 724 F.3d 256 (2d Cir. 2013), *cert. denied*, 134 S.Ct. 1938 (Apr. 28, 2014) ("New York Life") (certain policyholder dividends credited in December and paid in January, as well as termination dividends, did not satisfy the all-events test for accrual and, thus, were not deductible in the year credited).

[19] 782 F.3d 1354, at 1361.

[20] Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *Taxing Times*, Vol. 12, Issue 1, at 21 (March 2016).

[21] *Sears, Roebuck & Co. v. Commissioner,* 972 F.2d 858, 866 (7th Cir. 1992).

[22] *State Farm Mut. Auto. Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012).

[23] *Acuity v. Commissioner,* T.C. Memo 2013-209.

[24] *R.V.I. Guar. Co., Ltd. v. Commissioner,* 145 T.C. No. 9 (2015).

[25] Peter H. Winslow, "Subchapter L: Can You Believe It? Change in Tax Status of an Insurance Company—IRS Eliminates Catch-22 Situation," *Taxing Times,* Vol. 12, Issue 1, at 53 (March 2016).

[26] Section 808(b)(4) and (d)(3).

[27] *Principal Life Ins. Co. v. United States,* 70 Fed. Cl. 144 (2006).

[28] Treas. Reg. § 1.263(a)-4.

[29] Peter H. Winslow & Lori J. Jones, "When Are Guaranty Association Assessments Deductible?" *Taxing Times*, Vol. 2, Issue 2, at 24 (September 2006).

[30] Section 846(b)(1).

[31] Section 846(f)(2).

[32] S. Rep. No. 99-313, at 501 (1986); Staff of the J. Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986* ("1986 Blue Book"), at 602.

[33] H.R. Rep. No. 99-841, vol. II, at 361 (1986) (Conf. Rep.); 1986 Blue Book at 614.

[34] *Carcieri v. Salazar,* 555 U.S. 379, 129 S.Ct. 1058, 1063-64 (2009); *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-254 (1992); Peter H. Winslow, "Loss Adjustment Expenses for Life Insurance Companies," *Taxing Times*, Vol. 7, Issue 3, at 40 (September 2011).

[35] TAM 9538007 (June 13, 1995).

[36] Field Service Advisory, 1993 WL 1469637 (September 20, 1993).

[37] Treas. Reg. § 1.166-2(d)(1).

[38] I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies, LB&I-4-0712-009 (July 30, 2012).

[39] Notice 2013-35, 2013-24 I.R.B. 1240.

[40] I.R.C. §446: LB&I Directive Related to Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies, LB&I-04-0514-0050 (July 17, 2014).

[41] For a discussion of the Directive, see Eric Bisighini & Tim Branch, "Variable Annuity Hedging Directive—A Long and Winding Road," *Taxing Times*, Vol. 10, Issue 3, at 1 (October 2014).

[42] SSAP No. 86.

[43] H.R. Rep. No. 98–432, pt. 2, at 1401 (1984); Staff of S. Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984*, at 524 (Comm. Print 1984); 1984 Blue Book at 581.